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THE OIL AND GAS INDUSTRY AND ITS PRESENT TAX TREATMENT

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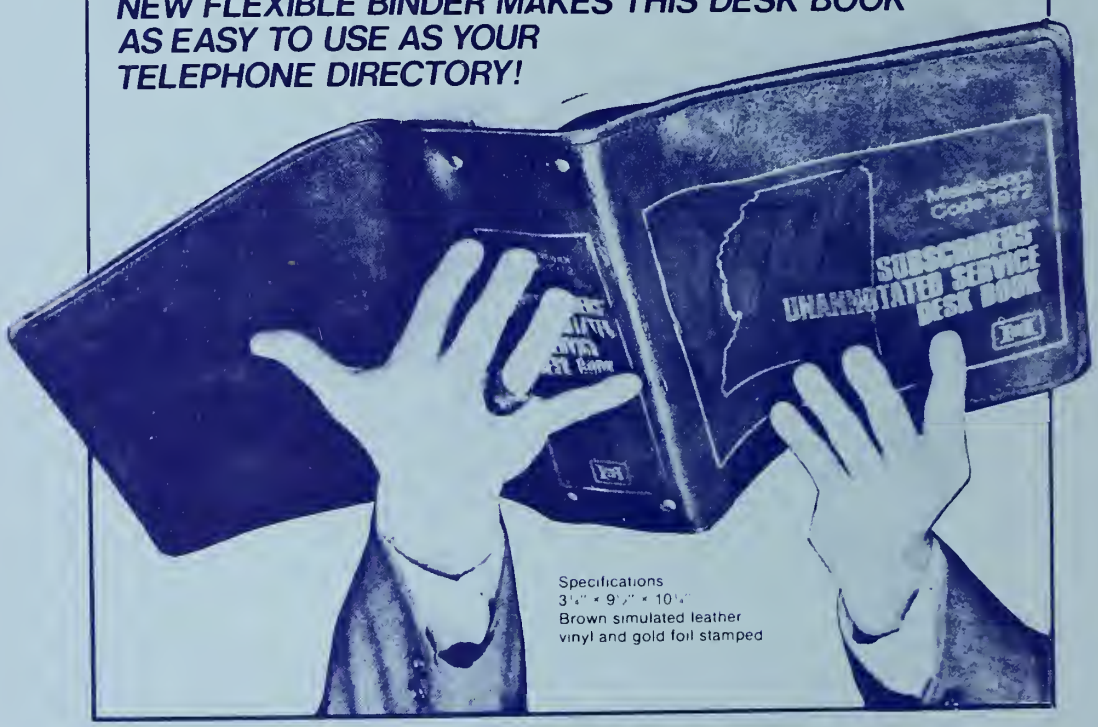

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Mississippi Law Journal

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VOLUME 45 NOVEMBER 1974 NUMBER 5

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The MISSISSIPPI LAW JOURNAL is published by University of Mississippi law students five times annually in January, April, June, September, and November. Editorial and business offices: Mississippi Law Journal, P. O. Box 146, University, Mississippi 38677.

Current subscription: $10.00 per year. Single issue, $3.00. Subscriptions are renewed automatically upon expiration unless the subscriber sends notice of termination.

Change of address: Members of the Mississippi State Bar send address changes to the Mississippi State Bar, P. O. Box 1032, Jackson, Mississippi 39205. All other subscribers send address changes directly to the Mississippi Law Journal. Include name, new address (including zip code) and old address. Please notify 45 days in advance to ensure prompt delivery.

Unless a claim is made for non-receipt of Journal issues within 6 months after the mailing date, the Mississippi Law Journal cannot be held responsible for supplying those issues without charge.

Second class postage paid at University, Mississippi 38677 and additional mailing offices.

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The Mississippi Law Journal is a member of the National Conference of Law Reviews.

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Mississippi Law Journal

JOURNAL of the MISSISSIPPI STATE BAR and the UNIVERSITY of MISSISSIPPI SCHOOL OF LAW

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THE PROTECTION OF THE ENVIRONMENT AND WORLD PUBLIC ORDER: SOME RECENT DEVELOPMENTS†

*Myres S. McDougal**
-and-
*Jan Schneider***

Man is both creature and moulder of his environment, which gives him physical sustenance and affords him the opportunity for intellectual, moral, social and spiritual growth. In the long and tortuous evolution of the human race on this planet a stage has been reached when through the rapid acceleration of science and technology, man has acquired the power to transform his environment in countless ways and on an unprecedented scale. Both aspects of man's environment, the natural and the manmade, are essential to his well-being and to the enjoyment of basic human rights—even the right to life itself.***

I. Introduction

A. The Globe as an Ecological Unit

It is widely recognized that our entire earth-space environment is an ecological unity both in a basic scientific sense and in terms of the interdependences of the social processes by which we exploit it. The plants, animals (including homo sapiens), and microorganisms that inhabit the planet are united with each other and with their nonliving surroundings by a network of complex and interdependent natural and cultural components which comprise a planetary "ecosystem." Within this comprehensive ecosystem, man alone has a dual role; he is both a natural symbiotic component and a conscious disrupter.

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†This paper was presented at the Second International Joint Conference of the American Division of the World Academy of Art and Science and the New York Academy of Sciences on *Environment and Society in Transition: World Priorities*, New York, May 1974, and is published here with the permission of the sponsors of that conference.

*Sterling Professor of Law, Yale University; B.C.L. 1930, Oxford University; J.S.D. 1931, Yale; LL.B. 1935, University of Mississippi; LL.D. 1966, Northwestern University.

**B.A. 1968, Pembroke College, Brown University; M.I.A. 1970, Columbia University; J.D. 1973, M. Phil. 1974, Yale University.

***Declaration of the United Nations Conference on the Human Environment, preamble.

It is the more specific ecological unities or interdependences—physical, engineering, and utilization—of this comprehensive ecosystem which make our whole earth-space environment a single sharable, and necessarily shared, resource. What is true about the sharability of the oceans, the atmosphere, the airspace and enfolding outerspace, and landmasses when considered separately, is no less true of the indivisible whole which they comprise. The appropriate perspective has been aptly stated by Barbara Ward and Rene Dubos:

> There is a profound paradox in the fact that four centuries of intense scientific work, focused on the dissection of the seamless web of existence and resulting in evermore precise but highly specialized knowledge, has led to a new and unexpected vision of the total unity, continuity, and interdependence of the entire cosmos.[1]

The same perspective is expressed in other words by Harold and Margaret Sprout:

> [T]he ecological way of seeing and comprehending envisages international politics as a *system of relationships* among *interdependent, earth-related* communities that share with one another an *increasingly crowded planet* that offers *finite* and *exhaustible* quantities of *basic essentials* of human well-being and existence.[2]

The most urgent need confronting us today is that of securing new and more precise scientific knowledge about the different unities and interdependences of our most comprehensive environment. With an increase in such knowledge, we might be able to devise more effective remedial measures to better conserve and develop the environment for future use and to secure the basic values of human dignity for which we maintain our different community processes.

B. Rising Demands for Better Protection of the Environment

Fortunately, demands are rising all about the globe for improved knowledge and more appropriate measures for environmental protection. These rising demands were dramatically illustrated in the environmental benchmark of "Stockholm '72." Three separate conferences on human environment took place in that city in that year.[3] The Dai Dong Independent Conference (its name being derived from an ancient Chinese concept: "For a world in which not only a man's family is his

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[1] B. WARD & R. DUBOS, ONLY ONE EARTH 30 (1972).

[2] H. SPROUT & M. SPROUT, TOWARD A POLITICS OF THE PLANET EARTH 14 (1972). *See also* H. SPROUT & M. SPROUT, MULTIPLE VULNERABILITY: THE CONTEST OF ENVIRONMENTAL REPAIR AND PROTECTION (Woodrow Wilson School of Public and International Studies 1972).

[3] For discussion of all three convocations, see Knelman, *What Happened at Stockholm*, 28 INT'L J. 28 (1972-1973).

family, not only his children are his children, but all the world is his family and all children are his.") was sponsored by the International Fellowship of Reconciliation (IFRC) and met from June 1-6. The official United Nations Conference on the Human Environment, with 1,200 delegates from 113 countries, was the most publicized of the three, and it met for 2 weeks from June 5-17. Finally, the official U. S. Conference was paralleled by an unofficial meeting organized by various citizens' groups and private individuals known as the Environment Forum. Although the substantive developments at both the official and unofficial gatherings disappointed many participants and observers, what happened at Stockholm is most significant in indicating that, at both elite and mass levels, environmental demands on the world decision process are becoming more comprehensive and more fully perceptive.

Unfortunately, however, these demands as yet are neither sufficiently comprehensive nor sufficiently perceptive. Specifically, it is still not widely recognized that there are environmental dimensions, just as there are human rights dimensions, to all the authoritative decisions taken in all our communities from local to global and that the rational making of these decisions requires that a comprehensive intelligence about the environment be brought to bear upon them. Similarly, it is not always recognized that beyond the mere infusing of relevant intelligence about the environment into the traditional flow of decisions, positive and dynamic programs for the better protection and more advantageous use of the whole earth-space environment in all its features (including atmospheres, oceans, airspace, landmasses) are required if common interest in survival and optimum order is to be served.

The full specification of an appropriate program in demand and response would require, much beyond our compass here, performance of a sequence of distinct but interrelated intellectual tasks, including: (1) The detailed specification, in their context of causes and consequences, of the more important problems arising from man's contemporary interaction with and exploitation of his environment; (2) the clarification in detail, from the perspective of an observer identifying with the whole of mankind, of basic general community policies in relation to each of these particular problems; (3) a survey of past experience, of prior trends in decision, at all levels of government, from local to global, in terms of approximation to clarified policies; (4) an investigation of the factors that have affected past decisions on particular problems; (5) the projection of probable future decisions and conditioning factors in relation to particular problems; and (6) the recommendation of new alternatives in constitutive process and public order prescriptions for the better securing of clarified policies.

C. *The Inherited Global Constitutive Process of Authoritative Decision*

The process of authoritative decision maintained by the larger general community for the resolution of environmental controversies and other matters is that of traditional international law, now built about the framework of the United Nations and the specialized agencies and regional organizations. This global decision process has lately begun active response to demands for the better protection of the environment,[4] as the very convocation and outcomes of the United Nations Conference on the Human Environment illustrate. The Conference adopted an Action Plan for the Human Environment which contained more than 200 specific recommendations for future international activities.[5] It also passed a Resolution on Institutional and Financial Arrangements, which formed the basis for creation by the United Nations General Assembly of the United Nations Environment Programme (composed of a Governing Council for Environment Programmes, a small Secretariat with an Executive Director, the Environment Fund, and an Environment Co-ordination Board).[6] Supportive efforts are being undertaken by a whole host of international organizations—governmental and nongovernmental, specialized and nonspecialized, general and regional.

There remain, nevertheless, certain special difficulties characteristic of the past operation of the larger community process. Planning and development activities at the international level, though among the most stressed, have been inadequate in both reach and detail. In consequence, and perhaps also as cause, the promotion or active advocacy of environmental policy alternatives before authoritative decisionmakers

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[4]For previous analysis of this subject by the present authors, see McDougal, *Legal Basis for Securing the Integrity of the Earth-Space Environment*, 184 ANNALS N.Y. ACAD. SCI. 375 (1971); Note, *New Perspectives on International Environmental Law*, 82 YALE L.J. 1659 (1973). *See generally* R. FALK, THIS ENDANGERED PLANET (1971); J. MCHALE, THE ECOLOGICAL CONTEXT (1970); H. SPROUT & M. SPROUT, TOWARD A POLITICS OF THE PLANET EARTH (1972). *See also* S. BRUBAKER, TO LIVE ON EARTH (1972); Bleicher, *An Overview of Environmental Legislation*, 2 ECOLOGY L.Q. 1 (1972); Goldie, *Development of an International Environmental Law—An Appraisal*, in LAW, INSTITUTIONS, & THE GLOBAL ENVIRONMENT 104 (J.L. Hargrove ed. 1972); Johnston, *International Environmental Law: Recent Developments and Canadian Contributions*, in CANADIAN PERSPECTIVES ON INTERNATIONAL LAW & ORGANIZATIONS 555 (R. MacDonald ed. 1974); Olmstead, *Prospects for Regulation of Environmental Law*, in THE PRESENT STATE OF INTERNATIONAL LAW 245 (International Law Association 1973); Teclaff, *The Impact of Environmental Concern on the Development of International Law*, 13 NATURAL RESOURCES J. 357 (1973).

[5]REPORT OF THE UNITED NATIONS CONFERENCE ON THE HUMAN ENVIRONMENT, U.N. Doc. A/Conf. 48/14, at 8-60 (1972) [hereinafter cited as REPORT].

[6]*Id.* 61. The U.N. General Assembly subsequently established UNEP by resolution 2997 (XXVII) of December 15, 1972, U.N. Doc. A/8370 (1973). *See also* Hardy, *The United Nations Environment Program*, 13 NATURAL RESOURCES J. 235 (1973).

also has been weak. Most importantly, there has been a relative absence of the centralized performance of the prescribing and applying functions in relation to international environmental law. It is small wonder that the overall public order of the environment has suffered.

D. The Continuing Problems

The problems we observe are, in sum, the continuing destructive impacts upon and spoliation of the environment and continuing unplanned exhaustion of resources, with loss of potential gains. The world's population increases at an alarmingly accelerating rate, with cumulative demands upon resources. Technological advances multiply the potentialities of destructive impact. Perceptions of policy alternatives and programs for ameliorative action remain inadequate, and the time is short for meaningful reorientation of the world decision process.

II. Clarification of Basic Community Policies

A. Our Commitment and Environmental Goals

The observational standpoint we recommend is that of the scholarly observer or decisionmaker who identifies, not merely with some single parochial community, but rather with the whole of man's many different—often concentric, and always interpenetrating—communities. The enlightenment we seek is that relevant to clarifying and implementing the common interests of all and to defending and extending the domain of institutions compatible with the fundamental concepts of human dignity.

The most general goal we recommend for environmental and other problems is that of protecting common and rejecting special interests. By "common interests" we refer to shared demands for values whose achievement is affected by conditions of interdependence or interdetermination. By "special interests" we refer to demands which are destructive of common interests in that they cannot be shared even in equivalences and their achievement is violative of the conditions of interdependence, imposing unnecessary harm upon others.

Within common interests, as contraposed to special, a distinction must be taken between inclusive interests and exclusive interests. By "inclusive" we refer to interests in activities that have significant transnational effects, that is, which importantly affect more than one territorial community. By "exclusive" we refer to interests in activities which predominantly affect only one territorial community. A further distinction may be made. Inclusive public order interests are demands for values plus supporting expectations about conditions of achievement, the expectations involving high degrees of collective impact upon the relationships referred to by the goals of the world community. In this

same class are communitywide participation in decision, or a lesser degree of participation by more than one component community of the world arena. Exclusive public order interests are demands for values plus supporting expectations, the expectations involving high degrees of particular impact, compatible with the goal values of the world community, and unaccompanied by high levels of collective impact.

The inclusive interests of peoples in the enjoyment of the environment, like those in any other necessarily shared resource such as the component oceans, atmosphere, airspace, and outerspace, relate to both minimum order and optimum order. By "minimum order" we refer to the conduct of activities by the processes of persuasion and agreement, with a minimum of unauthorized coercion and destruction. By "optimum order" we refer to cooperative activity in the utmost production and distribution of all demanded values in a world society. The inclusive interests of peoples in the protection of the environment extend beyond the mere sum of their interests in all the component sharable resources to the healthy functioning of the earth-space environment as a whole.

The exclusive interests of particular communities in the protection of the environment may similarly be described in terms of both minimum and optimum order. Every state has an interest in protecting its own internal order from external coercion and destruction. Every state has, further, an interest in promoting the healthy functioning of its own internal optimum order or social process. It is clear that both transgressions of ecological interdependencies and implementation of sound environmental policies have selective impacts upon different communities. The preoccupation of less industrialized countries with ensuring that environmental measures are not inaugurated at the expense of their basic economic and social development is a contemporary reflection of exclusive interest.

In more detailed specification and accommodation of inclusive and exclusive interests, certain more specific goals of environmental protection will require clarification. These are inextricably interrelated at multiple junctures with other cherished objectives of individual and group behavior. Even the negative goal of minimizing damage to the environment has a whole range of subgoals. These more particular subgoals include: Prevention (long-term efforts to minimize the occasions for injury), deterrence (precluding injury immediately threatened), restoration (putting an end to injuries already in process), rehabilitation (short-term binding up of wounds), and reconstruction (longer-term redesign of the situation to preclude further injury). Detailed recommendations with respect to each of these subgoals must vary enormously with context.

Beyond the basic goal of minimization of environmental injury, there are the positive motivations of optimum order. These include

preserving the environment and securing its most constructive use for the benefit of present and future generations. For proponents of human dignity, such an approach requires the detailed clarification of programs for optimalization of the shaping and sharing all values (or equivalents): power, respect, enlightenment, wealth, well-being (including health), skill, rectitude, and affection.

B. Recent Community Statements of Goals

Most recent international statements about goals and attempts at clarification have substantially, although not always explicitly, approximated our recommendations. The first Principle of the United Nations Declaration on the Human Environment summarizes the common conviction that:

> Man has the fundamental right to freedom, equality, and adequate conditions of life, in an environment of a quality that permits a life of dignity and well-being, and he bears a solemn responsibility to protect and improve the environment for present and future generations . . . .[7]

Similarly, the United Nations General Assembly, in its resolution providing for the institutional and financial arrangements of UNEP, declared itself:

> *Convinced* of the need for prompt and effective implementation by Governments and the international community of measures designed to safeguard and enhance the human environment for the benefit of present and future generations of Man.[8]

If we can believe the accompanying oratory and explications, the task of creating in the peoples of the world the perspectives necessary both for their more realistic understanding of their common interests in relation to the environment and for their invention, acceptance, and initiation of some of the measures required for the fulfillment of these common interests is well begun. The real question is to what degree the goals and related hortatory recommendations will actually be made effective in decision outcomes.

III. Trends in Decision and Conditioning Factors

A. Claims in Relation to the Process of Use

The potentialities afforded by world constitutive process and inherited public order for assisting movement toward improved environmen-

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[7] Report 4.
[8] *Id.* 61.

tal protection may be comprehensively and economically indicated in terms of the trends in decision in relation to certain basic perennial problems.

1. Allocation of Resources

It is a function of the global constitutive process to allocate resources between the inclusive and exclusive use and competence of the different territorial communities. The resources traditionally held open for inclusive enjoyment and decisionmaking include the oceans (including both the airspace above the oceans and the ocean floor), the void of space and the celestial bodies, international rivers, the polar regions, and some flow and stock resources within these areas. Left subject to exclusive appropriation are the landmasses of the world and their immediately proximate waters (in particular, internal waters and the territorial sea), their superjacent airspace, and the genetic, aesthetic, and cultural resources within these areas.[9] This basic pattern of allocation, it is readily apparent, has in its determinations of inclusivity and exclusivity greatly emphasized geographic factors.

In the past some claims to exclusive competence over basically sharable resources have been honored for the limited purpose of protecting certain very specific interests of coastal states. Thus, claims to contiguous zones and other special zones (*e.g.*, fisheries zones in the oceans and air-defense zones over the high seas) have been honored. The acceptance of these claims has been built upon the principle of "impact territoriality," which establishes the competence of a state with respect to external events which have impacts upon its territorial base. These zones are unlike territorial seas in that coastal states do not possess over them the whole bundle of competences known as "sovereignty," but rather are accorded a limited competence for the specified functional purposes.[10]

Most recently, an outstanding trend includes vast demands for shifts from inclusive to exclusive competence and from geographic factors to functional criteria in justification. In the area of oceans management, many states are claiming "exclusive economic zones" or "patrimonial seas" in which they assert the right to exercise exclusive competence over natural resource exploitation with varying degrees of control

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[9]For summaries of the regimes governing these resources, see Note, *supra* note 4, at 1661-63 & nn. 10-21. For comprehensive analysis of inclusive resources, see M. MCDOUGAL & W. BURKE, THE PUBLIC ORDER OF THE OCEANS (1962); M. MCDOUGAL, H. LASSWELL & I. VLASIO, LAW AND PUBLIC ORDER IN SPACE (1963).

[10]*See* Convention on the Territorial Sea and the Contiguous Zone, *done* April 29, 1958, [1964] 15 U.S.T. 1606, T.I.A.S. No. 5639, 516 U.N.T.S. 205, art. 24. *See also* M. MCDOUGAL & W. BURKE, THE PUBLIC ORDER OF THE OCEANS 584-606 (1962).

over transportation, communication, military uses, and scientific inquiry.[11] In addition, the United States has proposed that coastal state competence be extended to cover the entire migratory routes of anadromous fish (*e.g.*, salmon) and not just their spawning areas.[12] Either or both of these types of claims will result in broad areas of the oceans coming under some exclusive competence while remaining an inclusively enjoyed resource for other purposes. Finally, with particular reference to environmental considerations, Canada and some other states favor recognition of a residual competence of coastal states to establish environmental standards until and unless the international community reaches agreement on a suitable regime. Canada has already passed legislation, the highly controversial Arctic Waters Pollution Prevention Act,[13] establishing "environmental protection zones" out to 100 nautical miles from its Arctic coastline.

As far as the atmosphere is concerned, similar emerging—but not as yet carefully delineated—problems with respect to weather and climate modification are beginning to demand attention.[14] As an inadvertent byproduct of industrial processes, man is already having profound effects on weather and climate, and the technology is or will soon be available to make purposive alterations.[15] There is no escape, therefore, from questions of whether or not the atmosphere is open for such use by any and all states, and of who has decisionmaking competence—with all its attendant rights and responsibilities—over the activities involved. The fundamental question is whether climate and weather are to be regarded as inclusive resources under inclusive competence or are to be subjected to exclusive appropriation.

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[11]*See* Committee on the Peaceful Uses of the Sea-Bed and the Ocean Floor Beyond the Limits of National Jurisdiction, Report, 27 U.N. GAOR, Supp. 21, at 70, 73, 180, U.N. Doc. A/8721 (1972); *Id.* 28 U.N. GAOR, Supp. 21, vol. 2 at 4, vol. 3 at 1, 19, 23, 78, 87, 106, U.N. Doc. A/9021 (1973) [hereinafter cited as SEABEDS REPORT].

[12]Working Paper on Special Considerations Regarding the Management of Anadromous Fishes and Highly Migratory Oceanic Fishes, in 3 SEABEDS REPORT 11 (1973).

[13]CAN. REV. STAT. c. 47 (1970), text in 9 INT'L LEGAL MATERIALS 543 (1970); *see* Pharand, *The Arctic Waters in Relation to Canada*, in CANADIAN PERSPECTIVES ON INTERNATIONAL LAW & ORGANIZATIONS 434 (R. MacDonald ed. 1974); Beesley, *Rights and Responsibilities of Arctic Coastal States: The Canadian View*, 3 J. MARITIME L. & COMMERCE 1 (1971); *cf.* Bilder, *The Canadian Arctic Waters Pollution Prevention Act: New Stresses on the Law of the Sea*, 69 MICH. L. REV. 1 (1970). *But see* Henkin, *Arctic Anti-Pollution: Does Canada Make—Or Break—International Law?*, 65 AM. J. INT'L L. 131 (1971).

[14]*See* Samuels, *International Control of Weather Modification Activities: Peril or Policy?*, 13 NATURAL RESOURCES J. 327 (1973); Samuels, *Prospective International Control of Weather Modification Activities*, 21 U. TORONTO L.J. 222 (1971); Taubenfeld, *Weather Modification and Control: Some International Legal Implications*, 55 CALIF. L. REV. 493 (1967).

[15]*See* STUDY OF MAN'S IMPACT ON CLIMIATE, INADVERTENT CLIMATE MODIFICATION (1971).

2. Regulation of Enjoyment

The general community seeks to minimize the environmental losses, inadvertent or deliberate, that inevitably attend transnational interactions. It seeks also to effect the productive and harmonious use of the earth-space environment by present and future generations. In order to accomplish this dual objective, the most comprehensive constitutive process maintains a regime for regulating the enjoyment of resources.

a. Controlling Injurious Use

Resources Inclusively Enjoyed. With regard to resources inclusively enjoyed, many international agreements have been reached on means for controlling their injurious use and fixing liability and compensation for damage which nevertheless results. In the area of the law of the sea, several conventions seek to prevent pollution. Articles 24 and 25 of the 1958 Geneva Convention on the High Seas provide that "[e]very State shall draw up regulations to prevent pollution of the seas" from discharge of oil and dumping of radioactive waste respectively.[16] The 1954 International Convention for the Prevention of Pollution of the Sea by Oil[17] prohibits the intentional discharge of oil and oily mixtures into the sea, while the 1957 International Convention relating to the Limitation of the Liability of Owners of Seagoing Ships[18] and the 1962 Convention on the Liability of Operators of Nuclear Ships[19] deal with and limit the liability of shipowners for damage caused by their vessels.

The more recent treaties speak in stricter terms. The Intergovernmental Maritime Consultative Organization (IMCO) International Convention relating to Intervention on the High Seas in Cases of Oil Pollution Casualties (the "Public Law" Convention)[20] and International Convention on Civil Liability for Oil Pollution Damage ("Private Law" Convention)[21] were both drawn up at Brussels in 1969, but neither is yet in force. The former acknowledged the right of a coastal state to take necessary and proportional measures on the high seas to protect its coastline or related interests from pollution of the sea by oil. The latter

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[16]*Done* April 29, 1958, [1962] 13 U.S.T. 2312, T.I.A.S. No. 5200, 450 U.N.T.S. 82.

[17]*Opened for signature* May 12, 1954, [1961] 12 U.S.T. 2989, T.I.A.S. No. 4900, 327 U.N.T.S. 3. Amendments *adopted*, April 11, 1962, [1966] 17 U.S.T. 1523, T.I.A.S. No. 6109; October 21, 1969, annexed to I.M.C.O. Doc. A VI/Res. 175 (1970), text in 9 INT'L LEGAL MATERIALS 1 (1970).

[18]U.S. DEP'T OF STATE, BULL. No. 959, at 759-62 (1957). *See also* M. WHITEMAN, DIGEST OF INTERNATIONAL LAW 229-33 (1968).

[19]*Done* May 25, 1962, text in 57 AM. J. INT'L L. 268 (1963).

[20]*Done* November 29, 1969, text in 9 INT'L LEGAL MATERIALS 25 (1970).

[21]*Done* November 29, 1969, text in 9 INT'L LEGAL MATERIALS 45 (1970).

would impose strict liability on the owner of any oil tanker from which oil escaped after an incident at sea and which caused damage in the territory or territorial waters of a contracting state. It was supplemented by the 1971 International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage,[22] also yet to come into force, which would relieve shipowners from the "additional financial burden" imposed by the 1969 "Private Law" Convention and provide supplementary compensation for oil pollution victims up to a limit of $30 million.

Very recently, the 1972 Oslo Convention for the Prevention of Marine Pollution by Dumping from Ships and Aircraft[23] established an absolute prohibition against the dumping of certain highly toxic substances and regulated the dumping of all other substances in the region of the North Sea and North Atlantic Ocean, and the subsequent 1972 London Convention on the Dumping of Wastes at Sea[24] made similar black and grey lists applicable to all marine waters other than internal waters of states. The 1973 International Convention for the Prevention of Pollution from Ships[25] extended the 1954 Pollution of the Sea by Oil Convention with the intention of achieving the complete elimination of pollution of the sea by oil and other noxious substances and the minimization of accidental spills. Finally, the Oslo Convention states (joined by three landlocked neighbors) have just expanded their 1972 agreement into a comprehensive regime for that region of the seas by complementing it with a 1974 Convention for the Prevention of Marine Pollution from Land-Based Sources.[26]

The list of relevant conventions is long, and efforts at meaningful agreement are not limited to the oceans. The 1963 Treaty Banning Nuclear Weapon Tests in the Atmosphere in Outer Space and Under Water (the "Test Ban" Treaty),[27] while mostly a disarmament measure, also represents a very important environmental protection agreement. The 1967 Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space, Including the Moon and Other Celestial Bodies[28] (the "Outer Space" Treaty) provides that a state launching an object into space shall be "internationally liable for damage to another State Party to the Treaty or to its natural or juridical persons by such object,"[29] and the new 1972 Convention on International Liability

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[22]*Done* December 18, 1971, text in 11 INT'L LEGAL MATERIALS 284 (1972).

[23]*Done* February 15, 1972, text in 11 INT'L LEGAL MATERIALS 262 (1972).

[24]*Adopted* November 13, 1972, text in 11 INT'L LEGAL MATERIALS 1291 (1972).

[25]*Done* November 2, 1973, text in 12 INT'L LEGAL MATERIALS 1319 (1973).

[26]*Adopted* February 21, 1974, text in 13 INT'L LEGAL MATERIALS 352 (1974).

[27]*Done* August 5, 1963, [1963] 14 U.S.T. 1313, T.I.A.S. No. 5433, 480 U.N.T.S. 43.

[28]*Entered into force* October 10, 1967, [1967] 18 U.S.T. 2410, T.I.A.S. No. 6347, text in 6 INT'L LEGAL MATERIALS 386 (1967).

[29]18 U.S.T. 2410, 2415, T.I.A.S. No. 6347, text in 6 INT'L LEGAL MATERIALS 386, 388 (1967).

for Damage Caused by Space Objects provides that a launching state "shall be absolutely liable to pay compensation for damage caused by its space object on the surface of the earth or to aircraft in flight."[30]

Resources Exclusively Enjoyed. With respect to exclusive enjoyment of resources, the conferees at Stockholm made clear that such rights of states must be limited or balanced by responsibilities to ensure that their exercise does not result in damage to others. Principle 21 of the United Nations Declaration on the Human Environment contains the crucial balance:

> States have, in accordance with the Charter of the United Nations and the principles of international law, the sovereign right to exploit their own resources pursuant to their own environmental policies, *and* the responsibility to ensure that activities within their jurisdiction or control do not cause damage to the environment of other States or of areas beyond the limits of national jurisdiction.[31]

While the principle of responsibility of one state for damage caused in another is generally recognized, there have been only a few relevant international decisions on the subject. Most cited is the *Trail Smelter*[32] arbitration, in which an international tribunal found Canada liable for fumes emanating from a smelter located in British Columbia and doing damage in the State of Washington. The *Corfu Channel*[33] case, in which the International Court of Justice held Albania responsible under inter-

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[30]*Entered into force* September 1, 1972, text in J. PARROS & D. JOHNSTON, INTERNATIONAL LAW OF POLLUTION 373 (1974).

[31]REPORT 7 [emphasis added].

[32](United States v. Canada), 3 U.N.R.I.A.A. 1905, 1967 (1938, 1941), 35 AM. J. INT'L L. 684 (1941). The arbitral tribunal explained its reasoning in a much-quoted passage:

> [U]nder the principles of international law, as well as the law of the United States, no State has the right to use or permit the use of its territory in such a manner as to cause injury by fumes in or to the territory of another or the properties or persons therein, when the case is of serious consequence and the injury is established by clear and convincing evidence.
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> . . . .
>
> [T]he Tribunal holds that the Dominion of Canada is responsible in international law for the conduct of the Trail Smelter. . . . [I]t is . . . the duty of the Government of the Dominion of Canada to see to it that this conduct should be in conformity with the obligation of the Dominion under international law as herein determined.
>
> [T]he Trail Smelter shall be required to refrain from causing any damage through fumes in the State of Washington . . . .

Id. at 1965-66, 35 AM. J. INT'L L. 716-17 (1941).

[33][1949] I.C.J. 4. The Court had to decide whether Albania was responsible under international law for the explosions and resultant damage and whether the United Kingdom had violated the sovereignty of the People's Republic of Albania by reason of certain acts (including subsequent minesweeping) by the Royal Navy in Albanian waters. The Court rendered judgment in favor of the United Kingdom on both counts.

national law for damage to British ships from mine explosions in Albanian territorial waters, is another example. The third international judgment usually cited for its environmental implications is the *Lac Lannoux*[34] arbitration, where an international tribunal said that France would be strictly liable if, due to its hydroelectric utilization of a French lake, damage resulted to waters draining into Spain.

Similar policies are expressed in the more general practice of states. Traditional international law doctrines of "self-help" (including those of "self-defense," "self-preservation," and "security"),[35] as well as the somewhat less defined principle of "good neighborliness,"[36] allow a state confronted with a major threat to its exclusive resource interests to assert the necessary and proportional force to avert the danger or to abate its effects. In addition, in their various contiguous zones,[37] states exercise limited control over inclusive resources to prevent injury to particular exclusive interests. Coastal states have also certain other rights of abatement beyond their national jurisdictional limits (as, for example, those specified in the IMCO "Public Law" Convention).[38] All these rights build upon the basic principle, already mentioned, of "impact territoriality."

The most significant feature of the Stockholm formulation in light of these precedents is that Principle 21 explicitly extends liability to cover "areas beyond the limits of national jurisdiction."[39] The case law to date has been applied only narrowly for damage inflicted by one country or by its nationals on the rights, property, or territory of another country, its nationals or activities. Customary concepts of "self-defense," "self-preservation," "security," "good neighborliness," and "contiguous zones" have also been defined in terms of a sovereign-state

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[34](France v. Spain), 12 U.N.R.I.A.A. 281 (1957), 53 AM. J. INT'L L. 156 (1959). The arbitral tribunal held for France after finding that there would be full restitution of the diverted waters if the proposed electricity project were carried out. It made clear, however, that strict liability would have governed in the event of a finding for Spain:

> It could have been argued that the works would bring about a definitive pollution of the waters of the Carol or that the returned water would have a chemical composition or a temperature or some other characteristics which could injure Spanish interests. Spain could then have claimed that her rights had been impaired . . . .

Id. at 303, 53 AM. J. INT'L L. at 160-61.

[35]On self-help, see the U.N. Charter art. 51 and the complementary provision prohibiting "the threat or use of force" at art. 2, para. 4.

[36]The doctrine of "good neighborliness" is probably most highly developed in the law of international rivers, where a broad standard of recognition and respect for the multiple and alternative uses of the waters has evolved. *E.g.*, Case of the Territorial Jurisdiction of the International Commission of the River Order, [1929] P.C.I.J., ser. A, No. 23.

[37]*See* text accompanying note 10 *supra.*

[38]International Convention on Intervention on the High Seas in Cases of Oil Pollution Casualties, *done* November 29, 1969, text in 9 INT'L LEGAL MATERIALS 25 (1970).

[39]REPORT 7.

"self." The new statement of international community expectations—by its explicit provision—applies to the *res communes* as well as the exclusive possessions of other states.

b. *Facilitating Productive and Harmonious Use*

Resources Inclusively Enjoyed. Facilitating productive use of inclusive resources has traditionally been expressed jointly in terms of conservation and of apportionment. The early fisheries, pelagic sealing, and whaling conventions are examples of international agreements for these purposes.[40] Providing for the harmonious enjoyment in use of inclusive resources has required clarification of certain principles of jurisdiction and "rules of the road." Vessels, aircraft, and spacecraft are assimilated to the territory of their registry (with certain exceptions where there is concurrent jurisdiction). As to the host of ancillary rules of conduct, maritime law has over the centuries developed a comprehensive regime for regulating navigation, safety, and other operational facets of use.[41] Similar regulatory regimes have more recently been adopted for parallel problems in the areas of international rivers, air transport, and space exploration through the operations of the Helsinki Rules,[42] the International Air Transport Association (IATA), and the Outer Space Treaty[43]

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[40]*See, e.g.*, International Convention for the Northwest Atlantic Fisheries, *done* February 8, 1959, [1950] 1 U.S.T. 477, T.I.A.S. No. 2089, 157 U.N.T.S. 157, with several protocols up to that of November 29, 1965, [1970] 21 U.S.T. 576, T.I.A.S. No. 6841; North-East Atlantic Fisheries Convention, *done* January 24, 1959, 486 U.N.T.S. 157, 1963 U.K.T.S. 68; Convention on Fishing and Conservation of the Living Resources of the High Seas, *done* April 29, 1958, [1966] 17 U.S.T. 138, T.I.A.S. No. 5969, 559 U.N.T.S. 285; International Convention for the High Seas Fisheries of the North Pacific Ocean, May 9, 1952, [1953] 4 U.S.T. 380, T.I.A.S. No. 2786, 205 U.N.T.S. 65; Convention between the United States, Great Britain, Russia and Japan for the Preservation and Protection of Fur Seals, July 7, 1911, 37 Stat. 1542 (1911), T.S. No. 564, 104 B.F.S.P. 175, with sequels of December 8, 1942, 58 Stat. 1379 (1944), E.A.S. No. 415, 26 U.N.T.S. 364, and of February 9, 1957, [1957] 8 U.S.T. 2283, T.I.A.S. No. 3948, 314 U.N.T.S. 105.

For conventions on particular species, see S. LAY, R. CHURCHILL & M. NORDQUIST, 1 NEW DIRECTIONS IN THE LAW OF THE SEA 406-67 (1973). Examples of recent conventions along these lines include: Agreement on the Conservation of Polar Bears, *done* November 15, 1973, text in 13 INT'L LEGAL MATERIALS 13 (1974); Convention on Fishing and Conservation of the Living Resources in the Baltic Sea and the Belts, *done* September 13, 1973, text in 12 INT'L LEGAL MATERIALS 1291 (1973).

[41]*See, e.g.*, International Regulations for the Prevention of Collisions at Sea, *approved* May 17-June 17, 1960, [1965] 16 U.S.T. 794, T.I.A.S. No. 5813; International Convention for the Safety of Life at Sea, June 17, 1960, [1965] 16 U.S.T. 185, T.I.A.S. No. 5780, 536 U.N.T.S. 27.

[42]REPORT OF THE FIFTY-SECOND CONFERENCE HELSINKI 143-286, 447-533 (International Law Association 1966).

[43]Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space, Including the Moon and Other Celestial Bodies, *entered into force* October 10, 1967, [1967] 18 U.S.T. 2410, T.I.A.S. No. 6347, text in 6 INT'L LEGAL MATERIALS 386 (1967).

and related United Nations space resolutions.

In the context of the current Law of the Sea negotiations, this order is being greatly enlarged in scope.[44] First, states are coming to realize the seriousness of the problem of overfishing and its adverse impact on world protein supply and economic livelihood. Conservation of the fish stocks is said to be a major impetus behind the many proposals for new fisheries regimes and "exclusive economic zones." A second concept gaining general support is that of maximum utilization (variously defined). Several of the fisheries proposals make specific provision for other states to share in fishing activities when a coastal state underutilizes the fisheries resources outside its territorial sea. Thirdly, issues of equitable allocation and problems of landlocked and other geographically disadvantaged states are having to be faced openly. Of some 27 different resource proposals presented in the United Nations Committee on the Peaceful Uses of the Seabed and the Ocean Floor Beyond the Limits of National Jurisdiction (the "Seabeds Committee"), six deal essentially with the concerns of these geographically unfortunate states.[45]

Resources Exclusively Enjoyed. With respect to their exclusive resources, many states have gone farther than existing international norms in instituting positive programs of action. The United States Clean Air Act, 1967 Air Quality Act, and Clean Air Amendments of 1970,[46] which together aspire to set up a comprehensive system of air-quality control, afford an impressive example in just one area.[47] Not only are national governments declaring their environmental aspirations, but they are creating the infrastructure essential to achieve these goals. Just a few years ago "conservation" was a relatively minor interest associated primarily with birdwatchers and occasional whale enthusiasts, but now most of the major industrialized nations of the world have set up national departments of the environment. In this country, the Council on Environmental Quality (CEQ) has a highly significant advisory role, and the Environmental Protection Agency (EPA) undertakes major operational functions.

States, both individually and collectively, are increasingly making efforts to conserve and preserve exclusive resources. Under the recent 1973 UNESCO Convention for the Protection of the World Cultural and Natural Heritage,[48] states reciprocally have recognized their duty of "ensuring the identification, protection, conservation, presentation and

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[44]*See* Stevenson & Oxman, *The Preparations for the Law of the Sea Conference,* 68 AM. J. INT'L L. 1 (1974).

[45]*Id.* 13 n.42.

[46]The Clean Air Act, 42 U.S.C. §§ 1857 *et. seq.* (1970).

[47]For a discussion of these acts and their efficacy, see CONSERVATION FOUNDATION, A CITIZEN'S GUIDE TO CLEAN AIR (1972).

[48]*Adopted* November 16, 1972, text in 11 INT'L LEGAL MATERIALS 1358 (1972).

transmission to future generations" of the world's heritage, and they have bound themselves to take "effective and active measures" toward these ends. Similarly, the new 1973 Endangered Species Convention,[49] by which states agree to refrain from trade in species of wild flora and fauna in danger of extinction, represents such a collective conservation attempt covering some resources within the exclusive competence of nation-states. Finally, international aid and technical assistance for environmental management projects, if it is forthcoming, would also come in this category.

3. Planning and Development Functions in Relation to Resources

Resources Inclusively Enjoyed. Many of the most important resource use problems are associated with regional development and urbanization. Community planners have long advocated more effective planning of the physical environment and services of communities and subsequent development of resources in accordance with these plans. Many of these local considerations themselves have international implications (*e.g.*, amount of land devoted to food production, land activities which pollute the oceans and atmosphere, weather modification), and certainly the aggregate problem of planning and development of the resources of the shared earth-space environment is a matter of utmost international concern.[50] Until quite recently, nevertheless, these functions have been given little attention by the world community, and only initial projects have been undertaken.

There have in the past been attempts at shared-river-basins planning and development. The 1909 Boundary Waters Treaty between the United States and Canada[51] set up the International Joint Commission (IJC) to make recommendations for the effective use of these waters, and since then the Rhine and Danube Commissions have been set up for analogous purposes.[52] On a broader scale, the comprehensive efforts by many international agencies of the United Nations family to alleviate the drastic conditions caused by the drought in the Sahelian region in Africa and to improve the future prospects for the area are an unprecedented international custodianship enterprise.[53] Yet, as far as overall

[49]Convention on International Trade in Endangered Species of Wild Fauna and Flora, *done* March 3, 1973, text in 12 INT'L LEGAL MATERIALS 1085 (1973).

[50]*See* Tarlock, *Land Use Choice: National Perogative vs. International Policy*, 13 NATURAL RESOURCES J. 343 (1973).

[51]U.S.T. No. 549.

[52]*See* Bilder, *Controlling Great Lakes Pollution: A Study in United States-Canadian Environmental Co-operation*, in LAW, INSTITUTIONS, & THE GLOBAL ENVIRONMENT 294 (J.L. Hargrove ed. 1972); Stein, *The Potential of Regional Organizations in Managing Man's Environment*, in LAW, INSTITUTIONS, & THE GLOBAL ENVIRONMENT 253 (J.L. Hargrove ed. 1972).

[53]Almost all of the U.N. specialized agencies and several other agencies are partici-

inclusive international planning and development of the resources of the shared earth-space environment is concerned, the record is woefully deficient.

Resources Exclusively Enjoyed. With respect to exclusive resources, all nations have plans—some, however, have more formal term-projections and explicitly stated goals than others. The individual governmental ways and means are diverse. A hopeful collective initiative in terms of international cooperation for the planning and development of national or exclusive resources should be noted. In the preparations for the 1975 Vancouver Conference-Exposition on Human Settlements, countries with similar environmental problems in areas such as city planning, urban and rural services, low-cost housing, and accommodation of migrants are pooling their expertise for their joint and separate benefit.[54]

4. Managing the Access of Peoples to Resources

The issue of managing the access of peoples to resources involves reconsideration of criteria for membership in national communities (nationality), of freedom of movement between communities (transnational migration),[55] and of control of numbers of people (population).[56]

a. Nationality

Nationality is the vehicle by which an individual can advance claims to richer participation both in the exclusive resources of his particular national community and in the inclusive resources of wider communities. States historically have been permitted to prescribe and apply highly restrictive policies in the granting or denial of nationality. This has frequently resulted in "stateless persons," who are politically impotent both in the national territory in which they find themselves and in the international arena. Such practices dishonor the principle of indi-

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pating in projects in the Sahel. UNEP is also giving close attention to these projects, in line with decisions by its Governing Council to accord high priority to the areas of land, water and desertification.

[54]By its resolution 3001 (XXVII) of December 15, 1972, the U.N. General Assembly decided to hold a "United Nations Conference-Exposition on Human Settlements" and to accept the offer by the government of Canada to act as host. The Conference-Exposition is scheduled to take place from May 31, 1976, to June 11, 1976.

[55]On nationality and movement of peoples, see McDougal, Lasswell, & Chen, *Nationality and Human Rights: The Protection of the Individual in External Arenas*, 83 YALE L.J. 900 (1974).

[56]On international law and the population problem, see Nanda, *The Role of International Law and Institutions Toward Developing a Global Plan of Action on Population*, 3 DENVER J. INT'L L. & POLICY 1 (1973); THE WORLD POPULATION CRISIS: POLICY IMPLICATIONS AND THE ROLE OF LAW (Proceedings of the Am. Soc. Int'l L. regional meeting and the John Bassett Moore Soc. of Int'l L. symposium 1971).

vidual voluntarism and the maximization of human rights and human dignity.

Fortunately, however, some amelioration of historic attitudes towards nationality can be seen in the contemporary human rights program. The Universal Declaration of Human Rights provides that, at a minimum, "everyone has the right to a nationality" and that "no one shall be arbitrarily deprived of his nationality nor denied the right to change his nationality."[57] Furthermore, the same condition is implicit in the broader proclamation in the United Nations Environment Declaration: "Man has the fundamental right to freedom, equality, and adequate conditions of life . . . ."[58]

b. Movement of Peoples

The right to a nationality, if it is to be a meaningful vehicle of individual freedom and self-expression, must be accompanied by certain concomitant international rights: the right to return, the right to leave, and the right to stay in a country. Freedom of movement among national communities is required for their effectuation.

Traditionally, states have imposed severe limitations on international freedom of migration: immigration quotas, travel, and visa restrictions on the one hand and expatriation, deportation, and similar deprivations on the other. Such distressing precedents have been rejected in recent delineations of human rights—*e.g.*, the Universal Declaration on Human Rights,[59] the International Covenant on Civil and Political Rights,[60] the European Convention on Human Rights,[61] and the American Convention on Human Rights.[62] Yet, one has only to think of the plights of Soviet Jews, Ugandan Asians, and American draft resisters to realize that the world community is still far from having achieved its stated objectives. The goal of a high degree of voluntarism in international affiliation, participation, and travel is far from having been reached.

c. Population

Thirdly, the matter of numbers and concentrations of people (the "population question") is fundamental to international environmental policymaking. Population factors have to be approached both from the

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[57]G.A. Res. 217A, U.N. Doc. A/777 at 71, art. 15 (1948).

[58]REPORT 4.

[59]G.A. Res. 217A, U.N. Doc. A/777 (1948).

[60]*Opened for signature* Dec. 16, 1966, Annex to G.A. Res. 2200A, 21 U.N. GAOR, Supp. 16, at 49, U.N. Doc. A/6316 (1966), text in 61 AM. J. INT'L L. 861 (1967).

[61]*Adopted* April 3, 1954, Eur. T.S. No. 5, 213 U.N.T.S. 221.

[62]Text in BASIC DOCUMENTS ON INTERNATIONAL PROTECTION OF HUMAN RIGHTS 211 (L. Sohn & T. Buergenthal eds. 1973).

point of view of people as resources (human resources) and from that of people as molders of their own environment (human dignity). This raises urgent and contradictory policy considerations. On the one hand, people are an important base of power in the world community; but, on the other, no environmental measures in any dimension can be effective in the long term if the demographic explosion is not checked. At least to this extent, basic Malthusian doctrine remains as applicable as ever.

Until very recently population issues have been considered virtually exclusively within the decisionmaking competence of sovereign states. In the last decade or so, however, transnational efforts to control population growth and distribution have been inaugurated. They were at first narrowly limited to development assistance in the field of birth-control technology; but with the growing imminence and clearer perceptions of impending global demographic crisis, international cooperation has been increasing steadily in scope and magnitude—culminating in the denomination of 1974 as World Population Year and the preparation for a World Population Conference in 1975.[63]

B. Claims in Relation to the Global Constitutive Process

1. General Conception

The contemporary global community, like its constituent national communities, maintains a comprehensive process of decisionmaking in which elements of both authority and effective control are combined for the protection and expansion of both minimum and optimum order. The "constitutive process" is comprised of all decisions which characterize and identify the different authoritative decisionmakers, specify and clarify basic community policies, establish appropriate structures of authority, allocate bases of power for sanctioning purposes, authorize procedures for making the different kinds of decisions, and secure the continuous performance of all the different types of decision functions necessary to making and administering community policy. The "public order" decisions of the larger community, such as those that protect or fail to protect the environment, emerge in continuous flow from this established process.

This conception of constitutive process is to be sharply distinguished from the oft-asserted, restrictive, two-tiered approach to global decisionmaking, which attempts to draw a sharp division between international law and national legal processes. Concise expression of this latter view was offered most authoritatively by the late Professor Lassa Oppenheim.

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[63] *See* G.A. Res. 2542, 24 U.N. GAOR Supp. 30, at 49, U.N. Doc. A/7630 (1969). *See also* ECOSCC Res. 1672A-D (LII), 52 U.N. ESOSOC, Supp. 1, at 7, U.N. Doc. E/5183 (1972).

> International Law and Municipal Law are in fact two totally and essentially different bodies of law which have nothing in common except that they are both branches—but separate branches—of the tree of law. Of course it is possible for the Municipal Law of an individual state by custom or by statute to adopt rules of International Law as part of the law of the land, and then the respective rules of International Law become *ipso facto* rules of Municipal Law.[64]

Unhappily, this "two-tiered" approach has recently achieved resuscitation in the specific context of international environmental law.

> [T]he global and particular policy processes are not seen running side by side, one scoring here and one there. They are hierarchical rather than complementary. They are fused together to form a single two-tier process in which the understandings, apprehensions, and goals, continuously articulated, assessed and re-evaluated at the global level, are allowed to seep down to the second tier of the subsystems and gently civilize the harsh but unavoidable particular solutions to which individual states, pressed by technological flux, will increasingly resort.[65]

Similarly, the conception of a global constitutive process requires clear distinction from the other scholarly extreme: the so-called "monist theories" of international law. The clearest, brief exposition of these theories is perhaps that of Professor Josef Kunz.

> [*A*]*ll* the activity of the single States is regulated by the supraordinated Law of Nations. The so-called 'domestic affairs' of the single States are not the affairs which are *not* regulated by international law, but the affairs which a State, *under international law*, has the exclusive competence to regulate as it pleases . . . .[66]

The most complete devotion to this monistic primacy of international law underwrites a rather futilitarian despair. Thus, Professor Richard Falk concludes:

> A world of sovereign states is unable to cope with endangered-planet problems. . . . Such a system exhibits only a modest capacity for international cooperation and coordination. The distribution of power and authority, as well as the organization of human effort, is overwhelmingly guided by the selfish drives of nations.[67]

Avoiding the Scylla of legalistic mysticism and the Charybdis of

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[64]Oppenheim, *Introduction* to C. PICCIOTTO, RELATION OF INTERNATIONAL LAW TO THE LAW OF ENGLAND AND THE UNITED STATES at 10 (1915).

[65]Slouka, *International Environmental Controls in the Scientific Age*, in LAW, INSTITUTIONS, & THE GLOBAL ENVIRONMENT, at 208, 229-30 (J.L. Hargrove ed. 1972).

[66]Kunz, *The "Vienna School" and International Law*, 11 N.Y.U.L.Q. REV. 370, 399 (1934).

[67]R. FALK, THIS ENDANGERED PLANET 37-38 (1971).

academic fatalism, it may be possible to observe that people identify and interrelate, and make authoritative decisions, on multiple levels, from local to global or earth-space. Our presentation will be confined to brief descriptions of the transnational decisionmaking and implementation processes with regard to environmental problems.

2. Particular Functions

We describe the varying phases of the world constitutive process in terms of seven basic functions or culminating outcomes in decision: Intelligence, promotion, prescription, invocation, application, termination, and appraisal.

a. Intelligence

Intelligence is the obtaining, processing, and dissemination of information (including planning). The intelligence function is given great emphasis in the United Nations Environment Programme. The Action Plan adopted at Stockholm provided for a comprehensive global assessment program to be called "Earthwatch."[68] Earthwatch included functions divided into four categories: evaluation and review, research, monitoring, and information exchange. Of the 109 Recommendations adopted by the Conference, Recommendations 23, 25, 27, and 40 have provisions pertinent to these four respective areas.[69] At subsequent sessions of the UNEP Governing Council, a large number of representatives have expressed the view that high priority should be given to the Earthwatch program and that a beginning should be made with the monitoring component of the program by the establishment of a "Global Environ Monitoring System" (GEMS).[70]

Several important transnational environmental groups carry out environmental information gathering and dissemination activities. Some highly prominent examples are the Study of Critical Environmental Problems (SCEP), the Scientific Committee on Problems of the Environment (SCOPE), and the Study of Man's Impact on Climate (SMIC) of the International Council of Scientific Unions (ICSU), the Marine Environmental Protection Committee (MEPC) of the Intergovernmental Maritime Consultative Organization (IMCO), the Committee on the Challenges of Modern Society (CCMS) of the North Atlantic Treaty Organization (NATO), the International Union for the Conservation of Nature, and Natural Resources of the Council of Eu-

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[68] REPORT 59.

[69] *Id.*

[70] *See, e.g.*, REPORT OF THE GOVERNING COUNCIL OF THE UNITED NATIONS PROGRAMME, U.N. Doc. UNEP/GC/10, at 8 (1973).

rope.[71] On a bilateral level, the recent United States-Soviet Union treaty on the exchange of environmental information underlines the importance of this function as a prerequisite to other forms of environmental cooperation.[72]

Many subnational groups also perform vital environmental information activities. The requirement of environmental "impact statements" under Section 102(2)(C) of the United States National Environmental Policy Act of 1969 was designed to ensure that such activities are carried out by federal agencies before they undertake major federal actions with significant environmental effects.[73] Finally, countless research and analysis efforts by private individuals and institutions contribute to the overall global fund of environmental intelligence.[74]

Regardless of the recent proliferation of international environmental intelligence programs, the system is still somewhat incomplete. There has been only qualified recognition of the duty of states to warn and consult with other states concerning activities which risk significant adverse environmental effects on the other states. As one writer has expressed it, we lack an international analogue for national "impact statements."[75] This duty to provide proper warning was proposed by the Working Group of the Preparatory Committee for the Stockholm Conference for inclusion in the Environment Declaration. The aborted "Principle 20" would have read:

> Relevant information must be supplied by States on activities or developments within their jurisdiction or under their control whenever they believe, or have reason to believe, that such information is needed to avoid the risk of significant adverse effects on the environment in areas beyond their national jurisdiction.[76]

Unfortunately, due largely to an environmental dispute between Brazil and Argentina, this principle failed to win acceptance at the Conference. It was forwarded instead to the United Nations General Assembly, which incorporated only a modified version in a separate resolution

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[71]*See generally* Feraru, *Transnational Political Interests and the Global Environment*, 28 INT'L ORG. 31 (1974).

[72]Agreement on Cooperation in the Field of Environmental Protection, *done* May 23, 1972, text in 11 INT'L LEGAL MATERIALS 761 (1972). *See also* Union of Soviet Socialist Republics-United States: Memorandum of Implementation of Environmental Agreement, September 21, 1972, text in 11 INT'L LEGAL MATERIALS 1408 (1972).

[73]42 U.S.C. § 4332(C)(ii) (1970).

[74]*See* Feraru, *supra* note 71.

[75]Goldie, *International Impact Reports and the Conservation of the Ocean Environment*, 13 NATURAL RESOURCES J. 256 (1973).

[76]Draft Declaration on the Human Environment, U.N. Doc. A/Conf. 48/4, Annex, para. 20, at 4 (1972).

calling for "cooperation and good neighborliness" in the field of environmental protection.[77]

Our need for new and more precise environmental information in general and in specific situations is enormous. It is matched only by the need for better arrangements for processing and exchanging present knowledge.

b. Promotion

Promotion (or recommendation) is the advocacy of general policy. It involves the formulation and propagation of demands and the mobilization of support for new enactments.

This function has been rather inadequately performed on the transnational level in relation to environmental affairs. The whole United Nations Environment Programme (UNEP)—with its Governing Council, Secretariat, Fund and Co-ordinating Board—however, was set up basically to see that there are improved and better-coordinated international environmental initiatives in the future.[78] In particular, the Environment Secretariat and its Executive Director have been mandated by the General Assembly to act as "a focal point for environmental action and co-ordination within the United Nations system."[79]

Many other organizations are becoming quite actively involved in environmental promotion activities. The numerous nongovernmental organizations represented at the Stockholm Conference got together and promulgated their own "NGO Declaration." In it they made recommendations on policy and action in regard to the Conference agenda and pledged, *inter alia*, separately to "mobilize support for the Stockholm decisions" and together to "mobiliz[e] joint pressure for environmental change."[80]

The Club of Rome, with its now famous study of *The Limits to Growth*,[81] is an example of an international organization which has developed high potential for transnational environmental promotion activities. The International Council of Scientific Unions, largely through the SCEP, SCOPE, and SMIC studies,[82] has had similar effects. The Inter-

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[77]For the history of draft Principle 20, see Sohn, *The Stockholm Declaration on the Human Environment*, 14 HARV. INT'L L.J. 423, 496-504 (1973).

[78]*See* text accompanying note 6 *supra*.

[79]G.A. Res. 2997, 27 U.N. GAOR Supp. 30, at 43-44, U.N. Doc. A/8730 (1970).

[80]Text in *Environment Stockholm* 17 (U.N. CESI 1972). Eleven NGOs also promulgated the "Statement of Youth and Student NGO's." *Id.* 19.

[81]D.H. MEADOWS, D.L. MEADOWS, J. RANDERS, & W. BEHRENS, THE LIMITS TO GROWTH (1972).

[82]*See* text accompanying note 71 *supra*. SCIENTIFIC COMMITTEE ON PROBLEMS OF THE ENVIRONMENT, GLOBAL ENVIRONMENTAL MONITORING (1971); STUDY OF CRITICAL ENVIRONMENTAL PROBLEMS, MAN'S IMPACT ON THE GLOBAL ENVIRONMENT (1970); STUDY OF MAN'S IMPACT ON CLIMATE, INADVERTENT CLIMATE MODIFICATION (1971).

national Institute for Environmental Affairs was specifically established in 1971 to serve as a clearing house and catalyst for action.[83] Finally, certain domestically based public interest groups are performing international environmental promotion functions.[84] The Sierra Club has developed transnational concerns and an international organizational network to sustain them, and the Center for Law and Social Policy is active in foreign policy and international relations advocacy for inclusive environmental interests.

The initial thrust of all these promotion activities is to change the perspectives of effective elites to incorporate broader recognition of ecological imperatives. Their ultimate objective is to formulate and propagate environmental demands and to mobilize support for the enactment and application of new authoritative prescriptions at all levels of community participation.

c. Prescription

Prescription is the formulation and projection of policy as authoritative community expectation. Historically, the making of transnational law has progressed by articulated multilateral agreements and by unarticulated, habitual, cooperative behavior from which expectations about authority and control are derived. Five different types of international arenas house activity toward this end: diplomatic, parliamentary-diplomatic, parliamentary, adjudicative, and executive. In the field of international law, the trend is markedly toward the delegation of law-making functions to the executive arena, since it features specialized agencies with secretariats which can deal continuously with decision functions.

Recent achievements in the prescription of international environmental law are impressive. Within the area of the ocean environment alone, several examples have been mentioned, and there are many others: the 1958 Geneva Conventions on the Law of the Sea,[85] the International Convention for the Prevention of Pollution of the Seas by Oil (1954-1971),[86] the International Convention relating to Intervention on

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[83]*See, e.g.*, INTERNATIONAL INSTITUTE FOR ENVIRONMENTAL AFFAIRS, WORLD ENERGY, THE ENVIRONMENT & POLITICAL ACTION (1973).

[84]*See* note 71 *supra*. *See also* note 80 *supra*.

[85]Convention on Fishing and Conservation of the Living Resources of the High Seas, *done* April 29, 1958, [1966] 17 U.S.T. 138, T.I.A.S. No. 5969, 559 U.N.T.S. 285; Convention on the High Seas, *done* April 29, 1958, [1962] 13 U.S.T. 2312, T.I.A.S. No. 5200, 450 U.N.T.S. 82; Convention on the Territorial Sea and the Contiguous Zone, *done* April 29, 1958, [1964] 15 U.S.T. 1606, T.I.A.S. No. 5639, 516 U.N.T.S. 205.

[86]International Convention for the Prevention of Pollution of the Sea by Oil, 1954, *opened for signature* May 12, 1954, [1961] 12 U.S.T. 2989, T.I.A.S. No. 4900, 327 U.N.T.S. 3. Amendments *adopted*, April 11, 1962, [1966] 17 U.S.T. 1523, T.I.A.S. No. 6109; October 21, 1969, annexed to I.M.C.O. Doc. A VI/Res. 175 (1970), text in 9 INT'L LEGAL MATERIALS 1 (1970).

the High Seas in cases of Oil Pollution Casualties (1969),[87] the International Convention on Civil Liability for Oil Pollution Damage (1969),[88] the International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage (1971),[89] the Bonn Agreement for Cooperation in Dealing with Pollution of the North Sea by Oil (1969),[90] the General Principles on Marine Pollution[91] and the Statement of Objectives on the same subject (1972),[92] the Oslo Convention for the Prevention of Marine Pollution by Dumping from Ships and Aircraft (1972),[93] the International Convention on the Prevention of Pollution from Ships (1973),[94] and the Convention for the Prevention of Marine Pollution from Land-Based Sources (1974).[95]

All these conventions show an increasing awareness of the problems of the marine environment. They (especially the last-mentioned) also show growing recognition of the complexity of the ecological interdependences which are the most important conditioning factors of the policymaking process. Finally, there is a subsidiary trend toward increasing acknowledgement that, in the context of marine pollution, coastal states "have a particular interest in the management of area resources."[96]

Recent outcomes in prescription are, of course, not restricted to pollution and not restricted to the resources of the oceans. The "Test Ban" Treaty (1963),[97] the "Outer Space" Treaty (1967),[98] and the draft Convention on Liability for Damage Caused by Space Objects (1971)[99] all embody prescriptions with relevance to the environmental protection and use of the atmospehre and biosphere. The new "World Heritage"[100]

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[87]*Done* November 29, 1969, text in 9 INT'L LEGAL MATERIALS 25 (1970).

[88]*Done* November 29, 1969, text in 9 INT'L LEGAL MATERIALS 45 (1970).

[89]*Done* December 18, 1971, text in 11 INT'L LEGAL MATERIALS 284 (1972).

[90]*Entered into force* August 9, 1969, text in 9 INT'L LEGAL MATERIALS 359 (1970).

[91]REPORT, Annex 3.

[92]*Id.* at 48; *see* REPORT OF THE SECOND SESSION OF THE INTERGOVERNMENTAL WORKING GROUP ON MARINE POLLUTION, U.N. Doc. A/Conf. 48/IWGMP II/5, at 7-8 (1971) [hereinafter cited as IWGMP REPORT].

[93]*Done* February 15, 1972, text in 11 INT'L LEGAL MATERIALS 262 (1972). *See also* text accompanying notes 23 through 26 *supra*.

[94]*Done* November 2, 1973, text in 12 INT'L LEGAL MATERIALS 1319 (1973).

[95]*Adopted* February 21, 1974, text in 13 INT'L LEGAL MATERIALS 352 (1974).

[96]Statement of Objectives, correct text in IWGMP REPORT 7.

[97]1963 Treaty Banning Nuclear Weapon Tests in the Atmosphere in Outer Space and Under Water, *done* August 5, 1963, [1963] 14 U.S.T. 1313, T.I.A.S. No. 5433, 480 U.N.T.S. 43.

[98]1967 Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space, Including the Moon and Other Celestial Bodies, *entered into force* October 10, 1967, [1967] 18 U.S.T. 2410, T.I.A.S. No. 6347, text in 6 INT'L LEGAL MATERIALS 386 (1967).

[99]*Entered into force* September 1, 1972, text in J. PARROS & D. JOHNSON, INTERNATIONAL LAW OF POLLUTION 373 (1974).

[100]Convention for the Protection of the World Cultural and Natural Heritage, *adopted* November 16, 1972, text in 11 INT'L LEGAL MATERIALS 1358 (1972).

and "Endangered Species"[101] Conventions (1973), Convention on Fishing and Conservation of the Living Resources in the Baltic Sea and the Belts (1973),[102] Agreement on the Conservation of Polar Bears (1973),[103] and a variety of other multilateral and bilateral agreements are addressed to the positive goal of the wise use and preservation of environmental resources for future generations.

The central point is that these articulations of conceptions of prevailing law show both awareness of international environmental problems and a degree of willingness to do something about them. Clearly, if the inherited prescriptions about the protection of the environment are inadequate, the prescribing process itself offers few impediments to their being rendered more appropriate.

d. Invocation

Invocation is the provisional characterization of concrete circumstances in reference to prescriptions. In order to stimulate the application of community prescriptions, participants either must have the appropriate arenas open to them or find a surrogate or champion who does have access. The International Court of Justice (ICJ), for example, is at present closed to individuals and nonstate entities,[104] but states often bring cases there in a representative capacity for such participants. Community members who would complain about the violation of prescriptions for environmental protection, nevertheless, are likely to confront formidable barriers to obtaining a hearing.

The overwhelming trend of decision has been to permit the state of nationality, and only the state of nationality, to protect individuals and corporate entities. Furthermore, states are still regarded as having an option as to whether or not they will protect their nationals, for international law imposes no duty on a state to do so. This law has been developed in such famous cases as *Nottebohm*[105] (narrowly restricting state protection of individuals), *Flegenheimer*[106] (limiting state discretion as to who is its national for invocation purposes) and *Barcelona Traction*[107] (severely restricting competence to assert shareholders' interests in corporate affairs). The net effect of these decisions is denial

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[101]Convention on International Trade in Endangered Species of Wild Fauna and Flora, *done* March 3, 1973, text in 12 INT'L LEGAL MATERIALS 1085 (1973).

[102]*Done* September 13, 1973, text in 12 INT'L LEGAL MATERIALS 1291 (1973).

[103]*Done* November 15, 1973, text in 13 INT'L LEGAL MATERIALS 13 (1974).

[104]The STATUTE OF THE I.C.J., art. 34, provides that "[o]nly states may be parties in cases before the Court."

[105]Nottebohm Case, [1955] I.C.J. 4.

[106]Flegenheimer Claim, 25 I.L.R. 91 (Italian-United States Conciliation Commission 1958).

[107]Case Concerning the Barcelona Traction, Light & Power Co., Second Phase, [1970] I.C.J. 4.

of protection in international arenas of the minimum right to a hearing on the merits to the individual and group interests concerned. Similarly, in the national arenas of many countries, public interest groups are incapacitated because of restrictive provisions on standing to sue.

Recent trends are not encouraging. Not only do the old limitations remain extant, but recommendations in the context of the upcoming Law of the Sea Conference for a new specialized court (variously referred to as the Law of the Sea Court or International Maritime Court) and for a special fisheries commission again provide that only states would be parties to controversies to be resolved therein.[108]

Even should these deficiencies be cured and all participants be provided with a right to have their own claims heard, however, there would still remain the problem of how to secure protection of wider inclusive interests. This is the question of "who can speak for the commons?" In the *Nuclear Tests Cases,*[109] Australia and New Zealand are currently claiming that states should be allowed to sue not only on the basis of specification of injury to their own exclusive interests, but also as representatives of inclusive international environmental interests. This vital matter is, therefore, now directly before the International Court of Justice.

e. Application

Application is the final characterization of concrete circumstances in accordance with community prescription. Historically, the great bulk of the applications designed to put general community prescriptions into controlling effect in particular circumstances have been made in interactions between foreign offices. The fact that some participants have had to be alternatively both claimants and appliers has not been so much a source of bias as a guarantee of aggregate decision in terms of common interest.

In recognition of this traditional mode of application of international law and of the fact that the international system has developed very few mechanisms for supranational application, the relevant conventions rely on national policing systems. In the past, through the 1969 and 1971 IMCO Conventions,[110] such reliance has been placed solely on enforcement by flag states in maritime law and by the state of registry in space law. The 1972 London "Ocean Dumping" Convention, however,

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[108]*See* 5 SEABEDS REPORT § 21, at 1-9.

[109]Australia and New Zealand have each brought suit against France in the World Court in respect of a dispute concerning the holding of atmospheric tests of nuclear weapons by the French government in the Pacific Ocean. The I.C.J. issued an Order Concerning Interim Measures of Protection in each case on June 22, 1973, text in 12 INT'L LEGAL MATERIALS 749 (1973). On July 21, 1973, however, France conducted a nuclear test in the atmosphere over Mururoa in the Pacific Tests area; protests followed. *Id.*

[110]See notes 20 through 22 *supra.*

departed from past practice in recognizing complementary roles of flag and coastal states: the convention is enforceable by a contracting state not only against its flag and registry vessels, but also against vessels and fixed or floating platforms "under its jurisdiction and believed to be engaged in dumping."[111]

Full and prompt application of environmental prescriptions may, nevertheless, require more radical solutions—at least until adequate international cooperation is possible. The highly controversial Canadian Arctic "anti-pollution zone"[112] is described as an example of such unilateral action in furtherance of multilateral objectives. Within that zone, Canada has forbidden the deposit of wastes and other forms of pollution, imposed absolute civil liability and penalties for violations, and authorized "pollution prevention officers" to carry out extensive inspections and other regulatory measures. Canada asserts that such action is based, first, on the uniqueness and fragility of Arctic ecology, and secondly, on an emerging international law concept of pollution prevention and control authority of coastal states beyond their territorial waters.[113] The underlying rationale invoked, in other words, is again the principle of impact territoriality; until and unless the international community takes appropriate action to support its prescriptions for environmental protection and preservation, coastal states assert the right to protect their own interests.

Unilateral assertions can, of course, be directly contrary to the policies of transnational community expectation. When meant to insulate arbitrary and narrowly self-interested national actions from inclusive review (instead of simply providing an alternative arena for policy interpretation and other application), the consequences can be destructive both of inclusive substantive interests themselves and of confidence in the world constitutive process as a whole. The resistance to jurisdiction of the International Court of Justice asserted by Iceland and France in the environmentally related cases of *Fisheries Jurisdiction*[114] (concerning the legality of Iceland's declaration of a 50-nautical-mile exclusive

[111]London Convention on the Dumping of Wastes at Sea, *adopted* November 13, 1972, text in 11 INT'L LEGAL MATERIALS 1291, art. 7 (1972).

[112]CAN. REV. STAT. c. 47 (1970), text in 9 INT'L LEGAL MATERIALS 543 (1970).

[113]*See Canadian Prime Minister's Remarks on the Proposed Legislation*, 9 INT'L LEGAL MATERIALS 601 (1970). *See also* Beesley, *The Arctic Pollution Prevention Act: Canada's Perspective*, 1 SYRACUSE J. INT'L L. & COMMERCE 226, 235 (1973).

[114]In the *Fisheries Jurisdiction Cases*, the United Kingdom and the Federal Republic of Germany have challenged a claim by Iceland to extend its exclusive fisheries jurisdiction to a zone of 50 nautical miles around the island. The international agreements upon which these suits are based are found in 397 U.N.T.S. 275 (1961) and 409 U.N.T.S. 47 (1961) respectively; the Icelandic Resolution of the Althing on Fisheries Jurisdiction appears in 11 INT'L LEGAL MATERIALS 643 (1972). The International Court of Justice has issued a preliminary injunction and has decided it has jurisdiction in both cases. *See*

fishing zone) and *Nuclear Tests*[115] (concerning the legality under customary international law of nuclear tests in the atmosphere) is of this type. It is possible that either or both countries may have sound cases on the merits, but they should be prepared to defend them in an international forum against conflicting environmental claims.

This is not to say that there are easy answers to the polemics of unilateralism, bilateralism, regionalism, and multilateralism as approaches to the application of international environmental law. It is merely to realize that the traditional international legal order is essentially a laissez-faire system, unexperienced in collective enforcement actions to deal with nonsecurity matters. Given the urgency of present ecological imperatives, flexible approaches to application on the part of those most directly concerned are required until the world constitutive process develops its own adequate means of application.

f. Termination

Termination is the ending of a prescription and the disposition of legitimate expectations created while the prescription was in effect. The prescribing function does not itself operate to terminate a great many old prescriptions. Comparable procedures, therefore, must be applied for putting an end to old crystallizations of community expectations.

In the environmental context, due to the extensive and fundamental interdependences with other areas of policymaking, it will often be necessary to ameliorate the costs of change and of selective impacts. The Helsinki Rules on the Uses of the Waters of International Rivers[116] allow for this by providing for compensation of prior interests where international rivers are adapted to new uses. Similarly, special time delays and other compensatory measures may be called for in the inauguration of new fishing regimes and arrangements for mining of the oceans for manganese nodules and other substances. Stabilization bodies for the purpose of easing economic and trade dislocations based on old patterns of exploitation have, therefore, been proposed as part of the Seabeds regime to be created under the new Law of the Sea Treaty.[117]

In sum, where *rebus sic stantibus*[118] has been invoked without delib-

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Order of August 17, 1972, Concerning the Request for Indication of Interim Measures of Protection, *id.* 1069; Judgments on the Question of the Jurisdiction of the I.C.J. in the Fisheries Jurisdiction Cases, text in 12 INT'L LEGAL MATERIALS 290 (1973); Order Concerning the Continuance of Interim Measures of Protection, text in *id.* 743.

[115] *See* note 109 *supra*.

[116] REPORT OF THE FIFTY-SECOND CONFERENCE HELSINKI 447-533 (International Law Association 1966).

[117] On the international authority to be created to deal with the seabeds beyond national jurisdiction, see Stevenson & Oxman, *The Preparations for the Law of the Sea Conference*, 68 AM. J. INT'L L. 1, 4-8 (1974).

[118] "At this point of affairs" or "in these circumstances"—international law doctrine of changed conditions.

erate, inclusive performance of the termination function, serious economic and other disruptions in the world public order have been known to occur. The international crisis precipitated by the unilateral modification of concessions and the oil embargo of this year is just one outstanding recent example.

g. Appraisal

Appraisal is the evaluation of the manner and measure in which the public policies have been put into effect and of responsibility therefor. Basically it represents the intelligence function applied to the decision process itself.

The most comprehensive recent examples of this function are the "Jackson Report,"[119] which reviewed the United Nations Development Programme, and the report by the Pearson Commission,[120] which appraised the International Bank for Reconstruction and Development. The motivations behind the creation of the United Nations Institute for Training and Research (UNITAR), and the Joint Inspection Unit of the United Nations Secretariat involved performance of this function, and the same can be said of the United Nations Committee on Resources in a more directly environmental context.[121] Finally, the mandate for the United Nations Environment Programme explicitly charges the United Nations Governing Council with the responsibility "to receive and review the periodic reports of the Executive Director . . . on the implementation of environmental programmes within the United Nations system."[122]

An ever-present difficulty with appraisal is its sensitive character. Evaluations of success or failure are no trivial matter from the viewpoint of a responsible official or agency. From the point of view of the global constitutive process as a whole, self-appraisal of environmental performance is essential in order to be able to entertain realistic expectations about the consequences of change.

IV. Appraisal and Recommendations

In overview, two major characteristics of past trends may be observed. First, the underlying thrust in the formulation of past claims about resources has been primarily in terms of state-centeredness rather than commitment to inclusive community interests. There have been

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[119]A Study of the Capacity of the United Nations Development System, U.N. Doc. DP/5 (2 vols. 1969).

[120]Commission on International Development, Partners in Development (1969).

[121]UNITAR is a separate agency, a part of the United Nations system. The other two bodies are appraisal units within the U.N. Secretariat itself.

[122]G.A. Res. 2997, 27 U.N. GAOR Supp. 30, at 43, U.N. Doc. A/8730 (1973).

increasing claims of special state competence over resources and few efforts to regulate, plan, and develop their use and benefit for the shaping and sharing of values among all people. It is far from evident that these claims can be justified even as provisional measures by reference to the limitations inherent in the contemporary international decisionmaking system.

Second, such limitations as have been formulated from perspectives other than the specifically environmental or ecosystemic. The Stockholm Conference was in some measure successful in developing the missing environmental perspective, but the new international awareness is still fragile and tentative. The "energy crisis," for example, has provided disturbing indications of the perspectives of governments, multinational enterprises, the press, the public, and all sorts of groups and institutions. As one eminent analyst has put it: "There are signs of an increasingly widespread tendency to consider last year as the 'year of the environment' and this year as the 'year of the energy crisis.' "[123]

The many deficiencies in past decisions described above can be expected to continue in the absence of the formulation, evaluation, and implementation of more appropriate policy alternatives. Some of the policy alternatives requiring consideration may be indicated by summary reference both to the main features of the process of use of resources and to the different types of decision in world constitutive process.

A. Use of the Environment

1. Controlling the Seas and the Climate

In future decisions about competence over resources as high a degree of inclusive enjoyment as possible should be maintained for the oceans and seabed. This perspective should guide policymakers in the new legal order they intend to create at the upcoming Law of the Sea Conference. The expansion of exclusive coastal state competence over the oceans should be confined to the minimum, and, whatever the precise constitution of the new Seabeds Authority to deal with resources beyond the limits of national jurisdiction, it is essential that it both facilitate the widest shaping and sharing of the available values and protect the valid interests of all parties concerned once properly established. Although in some ways this task represents an unprecedented challenge to the inclusive decisionmaking system, certain analogies can be found in the work of existing international organizations, such as the International Civil Aviation Organization (ICAO).

Similarly, air, weather, and climate must be recognized as resources within the inclusive domain. Recommendation 70 of the Stock-

[123]Unpublished manuscript by Canadian Ambassador J. Alan Beesley in the possession of Professor McDougal and Ms. Schneider.

holm Action Plan recommended interstate consultations for activities which carry a risk of effects on climate.[124] The Bangkok Conference on World Peace Through Law went further and proposed "establishment at the earliest possible date of a Convention on Weather Control."[125] We fully support this recommendation and urge that the United States call now for a comprehensive international treaty concerning control of weather and climate modifications, both inadvertant and deliberate, which have effects or potential effects across national boundaries. We also recommend that some international agency, perhaps the World Meterological Organization (WMO), be explicitly charged with undertaking inquiry and recommendation in this area.

2. Regulation of Enjoyment

a. Controlling Injurious Use

Resources Inclusively Enjoyed. Governments and all effective elites must cooperate to withstand the assertion of claims to uses of sharable resources when such enjoyment can have injurious effects on either the rights and interests of other or common interests. In keeping with this aim, the new Law of the Sea Treaty must keep pace with the advances of technology to design an effective environmental code for the oceans, taking full account of the implications of such modern innovations as nuclear ships, supertankers, icebreakers, deepwater ports, and seabed mining facilities. Multilateral solutions must be sought to problems of inclusive resources, and states, individually as well as collectively, must accept responsibility for the effective implementation of such solutions.

As far as the atmosphere is concerned, the 1963 Test Ban Treaty[126] forbids atmospheric testing of nuclear devices. Since then, such tests have repeatedly been condemned by the international community. Considering the dire environmental consequences, governments at the Stockholm Conference again resolved "[t]o condemn nuclear weapons tests, especially those carried out in the atmosphere."[127] France and China, nevertheless, have refused to accept such decisions, and Australia and New Zealand are now protesting recent French explosions in the *Nuclear Tests Cases.*[128] It should be recognized that the ban first stated by the 1963 Treaty has now crystallized in general community expectations to such an extent as to become part of customary interna-

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[124]REPORT 40.

[125]BANGKOK CONFERENCE ON WORLD PEACE THROUGH LAW: RECOMMENDATIONS OF THE CONFERENCE (1969).

[126]Treaty Banning Nuclear Weapon Tests in the Atmosphere in Outer Space and Under Water, *done* August 5, 1963, [1963] 14 U.S.T. 1313, T.I.A.S. No. 5433, 480 U.N.T.S. 43.

[127]*Resolution on Nuclear Weapons Tests*, in REPORT 66.

[128]*See* note 109 *supra*.

tional law, and both France and China should be prepared to live up to any such pronouncement by the World Court.

Resources Exclusively Enjoyed. Principle 21 of the Stockholm Declaration provides the equitable basis for a regime of regulation of enjoyment of resources exclusively enjoyed so as not to injure others or the common interests.[129] It should be understood to encompass responsibility in such areas as land-based sources of atmospheric and marine pollution, liability for weather modification activities within the jurisdiction, and control of one state which could damage the environment of other states or the common environment, any similar effects of supersonic aircraft, disposal of radioactive wastes or nerve gas, and the whole range of new activities rendered possible by technological developments. The recent regional Convention for the Prevention of Marine Pollution from Land-Based Sources[130] should be extended to cover the oceans as a whole, and similar provisions should be made for enclosed and semi-enclosed seas. The time is also ripe for bilateral and multilateral weather modification agreements; and, as Canada has proposed to NATO's Committee on the Challenges of Modern Society, governments should undertake the study of the effects of supersonic flight in the atmosphere.[131]

b. Facilitating Productive and Harmonious Enjoyment

Resources Inclusively Enjoyed. Of first priority in this area is the viable organization of a regime for the high seas fisheries and of the resources of the seabed to encourage their utmost exploitation for the benefit of the whole of humanity, including both present and future generations. Any extensions of exclusive competence, in the form of special functional "zones" or otherwise, should be with a minimum of damage to the remaining inclusive uses of the oceans—in particular, uses of transportation, communication, and scientific research.

Resources Exclusively Enjoyed. In light of the history of draft principle 20,[132] the most immediate need is for adequate supply of information and full recognition of the duty to consult with other states concerning activities likely to affect them. Beyond this, technical data and other relevant information should also be supplied to some centralized international body—perhaps UNEP—in regard to proposed means of enjoy-

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[129] *See* text accompanying note 31 *supra.*

[130] *Adopted* February 21, 1974, text in 13 INT'L LEGAL MATERIALS 352 (1974).

[131] *See* Beesley, *The Canadian Approach—Environmental Law on the International Plane*, in PRIVATE INVESTORS ABROAD—PROBLEMS AND SOLUTIONS IN INTERNATIONAL BUSINESS IN 1973, at 239, 273 (V. Cameron ed. 1973).

[132] *See* Sohn, *The Stockholm Declaration on the Human Environment*, 14 HARV. INT'L L.J. 423, 496-504 (1973).

ment of exclusive resources which affect the regime for the common enjoyment of inclusive resources.

3. Planning and Development

Resources Inclusively Enjoyed. The most urgent need is for overall organizational arrangements to integrate intelligence, planning, and promotional activities with respect to all the varying components and features of the earth-space environment. The Governing Council of UNEP is to some extent charged with these functions, but it has not been endowed with the capabilities for their continuous performance. Aided by such broadly inclusive planning, actual development might go forward most successfully on a regional basis. Such regionalism should, however, take account of the larger ecological unities and be organized in accordance with natural ecological subsystems rather than synthetic political agglomerations.

Resources Exclusively Enjoyed. Comprehensive planning and development is needed in all countries at all levels: local, metropolitan, drainage basins, national, and transnational levels. Many countries already have environmental agencies or ministries for overseeing and managing the resources they enjoy exclusively, and the status and performance of these bodies should be improved. Whatever the institutional architecture, the function of planning and development needs to be provided by governments with respect to all environmental variables. Cooperative planning for exclusive resources (as illustrated by the Conference-Exposition on Human Settlements)[133] is useful, but it is also essential that responsibility be delegated to and assumed by continuing organizations which can implement the policies by actually carrying out the planned development.

4. People in Relation to Resources

Increased voluntarism in personal choice should be the goal of the international community as far as *nationality* and *migration* of peoples is concerned. In the final analysis, however, neither this goal nor any other goal of environmental protection, preservation, and enhancement can be made realistic in the absence of effective checks on *numbers* of people.

Voluntary restriction would also, of course, be the most desirable policy with respect to population growth—but its time may be past. It is essential, internationally and nationally, to make available the education and technology necessary for voluntary birth control. Yet there remain to be removed certain legal impediments to voluntarism—not

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[133] *See* note 54 *supra*.

only anti-abortion laws, but all anachronistic regulations which still prevent free access to and distribution of family planning information and contraceptive material.[134] Positive educational and promotional efforts on the part of Zero Population Growth (ZPG) and other programs should further be welcomed. Beyond this encouragement of voluntarism, the case for planned, compulsory regulation of reproduction, as compatible as possible with basic freedom of choice, might be given a fuller hearing.[135] It might be found preferable and possible for global decisionmakers (rather than leaving the determination to the apocalyptic horsemen) to agree on policies that, among other things, take account of human rights to a liveable environment and a decent quality of life as well as of the right to individual propagation, of differential rates of resource consumption as well as of differential reproduction rates, of the rights of women to self-expression and effectuation as well as of the claims of nations to people as bases of power.

This is World Population Year, the declaration of which implies acute awareness of these problems. The 1975 World Population Conference will face an extraordinarily difficult challenge to cooperative policymaking and implementation.

B. World Constitutive Process

1. Intelligence

If fully implemented, "Earthwatch"[136] could provide the international community with a comprehensive environmental intelligence function. High priority is therefore accorded to its rapid inauguration. Despite its promise, the system could bear improvement.

First, in addition to biogeochemical information, the assessment program should seek to incorporate intelligence regarding the social factors that are also fundamental to the "environmental" perspective. Social scientists have only just begun to develop "social indicators" that would enable standard recording of these variables,[137] but some sort of monitoring of social or sociological costs and benefits is essential to enable any meaningful assessment of policymaking for the human environment. Second, the program should be expanded to identify and keep track of developments affecting the environment both in the international and in national legal systems. The second session of the UNEP

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[134]*See* Pilpel, *Legal Impediments to Voluntarism*, in THE WORLD POPULATION CRISIS: POLICY IMPLICATIONS AND THE ROLE OF LAW, *supra* note 56, at 83.

[135]*See* Montgomery, *The Case for Compulsory Regulations of Reproduction*, in THE WORLD POPULATION CRISIS: POLICY IMPLICATIONS AND THE ROLE OF LAW, *supra* note 56, at 67.

[136]REPORT 59.

[137]*See, e.g.*, B. RUSSETT, H. ALKER, K. DOUTSCH, & H. LASSWELL, WORLD HANDBOOK OF POLITICAL AND SOCIAL INDICATORS (1964).

Governing Council gave a mandate to the Executive Director to convene further informal working groups of legal experts to advise him on how best to contribute to the future development of international environmental law,[138] but this is only a very minor aspect of the overall function. Lawyers in general must accept the role of committed activists, rather than hoping that the small secretariat will provide the momentous impetus needed. Third, as a basic foundation to all of this intelligence activity, further studies should be undertaken to clarify the confusions and difficulties of *The Limits to Growth*[139] and to evaluate its basic recommendation of "zero-growth" economic strategies in light of both natural and social conditioning factors.[140] At the present time, there is no global, little regional, and inadequate national political-economic planning for the long-term future. Fourth and finally, freedom of scientific and social scientific research is fundamental to the successful implementation of Earthwatch. At the Law of the Sea Conference[141] and elsewhere, the decision should be that all presently inclusive resources are kept open to scientific inquiry, and sincere efforts should be made to extend freedom of information even to resources exclusively enjoyed insofar as necessary for comprehensive international policymaking.

2. Promotion

Lawyers, scientists, scholars, citizens, and others might become concerned advocates and mobilize support among effective elites, for appropriate environmental policies. One has only to think of the widespread demand for a moratorium on whaling, including its promulgation in Recommendation 33 of the Stockholm Action Plan, to recognize how little international public opinion alone did for the whales.[142] It is essential to supplement hortatory solicitations by mobilizing support within relevant arenas.

International public opinion, although insufficient in and of itself, is not inconsequential. Environmental advocates should be putting more energy and channelling more resources into the supportive activities of education, training, and public information. Because of the scope and expense characteristic of such campaigns, in our age of mass participation and mass thrust of communications technology, specially organ-

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[138]REPORT OF THE GOVERNING COUNCIL OF THE UNITED NATIONS ENVIRONMENT PROGRAMMEE, U.N. Doc. UNEP/GC 126, at 19.

[139]D.H. MEADOWS, D.L. MEADOWS, J. RANDERS, & W. BEHRENS, THE LIMITS TO GROWTH (1972).

[140]*See, e.g., The No-Growth Society*, 102 DAEDALUS (Fall 1973).

[141]*See* Stevenson & Oxman, *The Preparations for the Law of the Sea Conference*, 68 AM. J. INT'L L. 1, 28-30 (1974).

[142]REPORT 23. The moratorium was subsequently rejected 1 month later at the next session of the International Whaling Commission.

ized public interest groups backed by charitable foundations can and do make a unique contribution.

3. Prescription

The Stockholm Conference clarified a lot of customary expectations, and the United Nations General Assembly has since reinforced many of these expectations. Environmental policy has also been crystallized in a number of international agreements. The prescriptive order is, nevertheless, incomplete. We recommend, therefore, that the International Law Commission or some other equivalent legal body (perhaps under the auspices of UNEP) be commissioned to make studies (as the ILC once did on the law of the sea)[143] of potential international environmental norms to be able to recommend standards of behavior and action. Greater use might be made of the United Nations General Assembly, of delegations of competence to specialized bodies, and of procedures comparable to those of the ILC, for securing the authoritative promulgation of such standards. Along with this initiative, support should be given to the movement for uniform national laws about the environment—at least insofar as they have transnational reach (environmental, trade, development assistance, or otherwise).

Concerning particular substantive areas, marine environmental protection will be a major concern of the Law of the Sea Conference, and many agreements can be expected to evolve out of that umbrella exercise. International decisionmaking at the World Population Conference will deal with the most pressing international environmental issue today. It is past time for negotiation of conventions on land-based sources of all marine pollution and on weather and climate modification. The environmental effects of supersonic aircraft are also worthy of imminent consideration.

4. Invocation

The principal requirement for improvement of the invocation function is for nonofficial actors to be accorded greater access to relevant arenas. On the international plane, short of change in the Statute of the International Court of Justice, this can be better achieved both by increased willingness of national governments to represent environmental causes and public interest groups and by provision of alternative international arenas open directly to nongovernmental actors. Through development of uniform national laws and on the individual national level, what is needed is relaxation of standing requirements before courts and

[143] *See particularly* INT'L L. COMM'N REPORT, 11 U.N. GAOR Supp. 9, U.N. Doc. A/3159 (1956), text in 51 AM. J. INT'L L. 154 (1957).

administrative tribunals to accord greater recognition to groups advocating common environmental interests.

A further idea deserving discussion is provision of an international ombudsman charged with invoking processes or intervening therein as representative of inclusive concerns when the common environment is threatened.[144] Whether this be the Executive Director of UNEP or some other individual or organization, the ombudsman would have to be directly connected with the Earthwatch intelligence facilities and supplied with a competent legal staff.

5. Application

As far as the application function is concerned, the authority of particular states to make applications of international standards appropriately clarified should be recognized and extended. This is especially so where the applying state has an exclusive interest compatible with and in furtherance of inclusive community interests—such as in the cases of Canada in seeking to protect the unique environment of the neighboring Arctic, and Australia and New Zealand in seeking to prevent threats of radioactive contamination of the atmosphere in South Pacific areas.

The environmental role of nonstate appliers should also be enhanced. A special World Environment Court does not seem to be called for at this time. The International Court of Justice can, however, be streamlined (through use of, among other things, chambers and assessors),[145] and other dispute settlement procedures (negotiation, good offices, mediation, conciliation, arbitration, judicial settlement in other courts, and administrative tribunals) should be tailored more readily to give greater weight to environmental factors in reaching their decisions.

6. Termination

The biggest problems in termination occur with respect to developing countries. At Stockholm it was repeatedly emphasized that in the developing countries most of the environmental problems are caused by underdevelopment.[146] The efforts of advanced industrial states to combat the ills caused by modern technological development, therefore, should not be allowed to preclude the economic and social progress of the poorer nations. In the short term, special provisions to accommodate

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[144]*See* Gardner, *The Role of the U.N. in Environmental Problems*, 26 INT'L ORG. 237, 254 (1972).

[145]See the suggestions of International Court of Justice Judge Philip Jessup in *Do New Problems Need New Courts?*, 65 PROCEEDINGS: AM. SOC. INT'L L. 261 (1971).

[146]*See, e.g.*, DEVELOPMENT AND ENVIRONMENT 6 *passim* (United Nations Conference on Human Environment 1971).

the legitimate expectations of developing countries may result in the creation of "pollution havens" and other undesirable side effects. In the longer term, however, all nations individually and collectively must accede to new prescriptions more fully reflecting environmental imperatives.

7. Appraisal

It is perhaps too early to expect major transformations as a result of the contemporary upsurge of environmental concern in the world community. UNEP, however, has already begun appraisal of the functioning of the United Nations system for the environmental perspective, and this evaluation will continue and hopefully will become more comprehensive. As far as the carrying out of public policies by nonofficial actors is concerned, universities, foundations, private scholars, and concerned citizens must shoulder responsibility for the appraisal function. In this respect, conferences have a major significance in stimulating the more comprehensive and perceptive development of international environmental policymaking.

V. Conclusion

The task of highest priority for all who genuinely are committed to a more appropriately conserving enjoyment of our most comprehensive environment, including all its great sharable resources, is that of creating in the peoples of the world the perspectives necessary both for their understanding of the conditions that affect the achievement of their common interests and for their invention and initiation of the detailed changes in global constitutive process that can secure such common interests. It is the confused, disoriented, and conflicting perspectives of the state-centered effective elites of the world which maintain both the suicidal patterns in spoliation and destruction of necessarily shared resources and the woefully inadequate responding decisions by the contemporary global constitutive process; it will require an enormous collective program in fundamental education and more general worldwide communication to change these perspectives. We do not share the views of observers who ground contemporary concern for the environment only upon imminent crises with respect to particular resources; the crisis is permanent and the resources affected comprise the whole earth-space ecosystem. The most appropriate perspective is that embodied in the fable of the lily pond: the lily plant doubles in size each day; if allowed to grow unchecked, it will cover the pond in 30 days, choking off all other forms of life in the water. So what happens?

> For a long time the lily plant seems small, and so you decide not to worry about cutting it back until it covers half the pond. On what day will that be? On the twenty-ninth day, of course. You have one day to save your pond.[147]

[147]D.H. MEADOWS, D.L. MEADOWS, J. RANDERS, & M. BEHRENS, THE LIMITS TO GROWTH 29 (1972).

THE OIL AND GAS INDUSTRY AND ITS PRESENT TAX TREATMENT†

*John Howard Shows**

I. Introduction

The United States is facing a severe energy problem. if not a catastrophic crisis. Recently, there has been gas rationing, cold water, cold homes or hot homes (depending upon the season) and no Sunday driving—each a self-proclamation of things gone awry. The need for oil and gas in greater and cheaper quantities is self-evident. This requirement can be obtained only by an industry willing to explore for new oil and gas fields. Within this context it is relevant to analyze the present tax policy regarding percentage depletion and intangible drilling costs (intangibles) which allegedly provide the oil industry an incentive for exploration. A discussion of either percentage depletion or intangibles will provoke varied reactions; passions often reach flammable proportions when oil or gas is combined with taxes. Both supporters and detractors are vehemently and absolutely positive of their position.

Regarding percentage depletion, it has been stated:

> Percentage depletion is probably one of the most, if not the most, hotly debated sections of the Federal Tax Code. A large part of this debate has concerned the effects of percentage depletion on the distribution of income (specifically, to what extent is the petroleum industry's tax burden "too low") and the allocation of resources within the economy (including risk compensation and tax neutrality).[1]

The depletion sections of the Internal Revenue Code, and more specifically the percentage depletion sections, are highly controversial and among the "most frequently assailed sections of the code."[2]

Percentage depletion is by no means the only controversial provision of the income tax structure affecting the oil and gas industry; the right to deduct currently intangible drilling and development costs has also evoked dispute because of benefit to the oil and gas industry.

> Whatever the merit, if any, in these extreme views, the story of taxation of the oil and gas industry in terms of the depletion allowance alone is

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†This article began as a paper prepared for a seminar on tax policy while the author was attending the National Law Center at George Washington University, Washington, D.C.

*Young, Young & Scanlon, Jackson, Mississippi. B.A. 1968, J.D. 1970, University of Mississippi; LL.M. 1974, National Law Center, George Washington University.

[1]Statement of Robert M. Spann, *Panel Discussions on General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 9, at 1309 (1973).

[2]Note, *Petroleum Depletion Allowances: A Justification*, 55 Ky. L.J. 158 (1966).

> incomplete. Of substantial, if not equal, importance is the treatment of intangible drilling and development costs. It is likely that in the tax planning councils of oil and gas operators, more attention is devoted to consideration of the deduction of intangibles than to depletion. The treatment accorded intangible drilling and development costs is so important that it should not be relegated to a position of inferior significance.[3]

With these brief introductory remarks it is apropos to note that the purpose of this article is to delineate the basic concepts of the depletion allowance and of the deduction of intangible drilling costs set forth in the Internal Revenue Code and to analyze the validity of these concepts in relation to our present national energy needs. Various arguments of both recent and ancient vintage will be analyzed to determine their legitimacy.

II. DEPLETION

As an income tax concept under the Internal Revenue Code, depletion is a creature of Congress and may be discontinued at any time if Congress determines that such action is necessary. It is not akin to the economic or geological concept of depletion, which remains unchanged regardless of the fate of depletion as a tax concept.[4] The Supreme Court has held that the depletion allowance as a taxation deduction is purely a "matter of congressional grace."[5] The income tax concept, however, is based upon the geological fact that the extraction of minerals from the land gradually exhausts the capital investment in the mineral deposit. As a tax concept, the depletion allowance is minimally connected with the taxpayer's capital investment and is not limited to a recoupment of the original investment. Depletion depends, not upon the units produced, but upon the income derived from the mineral produced. The sale of the mineral becomes the important factor.[6] This will be examined more closely in a later section of the article.

A. Historical Perspective Prior to 1954

The depletion allowance was first instituted for oil and gas in the Revenue Act of 1916.[7] The Act provided that a "reasonable allowance"

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[3]Fielder, *The Option to Deduct Intangible Drilling and Development Costs*, 33 TEXAS L. REV. 825 (1955).

[4]4 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 24.02 (rev. 1973).

[5]Commissioner v. Southwest Exploration Co., 350 U.S. 308, 312 (1956).

[6]C. BREEDING, F. BURKE & A. BURTON, INCOME TAXATION OF NATURAL RESOURCES, § 8.01 (1972) [hereinafter cited as C. BREEDING]; *see* Treas. Reg. §§ 1.611-2(a), 1.613-1 (1960).

[7]Ch. 463, 39 Stat. 756.

> In the case of oil and gas wells a reasonable allowance of actual reduction in flow

was not to exceed cost or value on March 1, 1913; thus an inequity resulted from those properties producing prior to March 1, 1913. Such depletion allowance was based on cost, whereas those properties discovered after March 1, 1913, had a depletion allowance based on value.[8] In response to this disparity, Congress included in the Revenue Act of 1918[9] a new concept known as "discovery depletion."[10] This type of depletion allowance was intended to provide an incentive for exploration and development of oil and gas. The basis for the depletion was the fair market value of the discovered property either on the date of discovery or 30 days thereafter. Thus the taxpayer was entitled to recover the capital *value* of the property, not the amount of capital invested in the enterprise.[11] Within a few years it became obvious that such a system with its vague terms of "fair market value" and "discovery" was difficult to administer and produced uneven results.[12] Thus in 1926 under the Internal Revenue Act of 1926[13] Congress abandoned the concept of "discovery depletion" for oil and gas properties.[14] Within the 1926 Act a provision for a reasonable allowance to recover cost was continued,[15] and there was

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and production to be ascertained not by the flush flow, but by the settled production flow or regular flow, . . . such reasonable allowance to be made . . . under rules and regulations to be prescribed by the Secretary of Treasury. *Provided*, that when the allowance authorized . . . shall equal the capital originally invested, or in the case of purchase prior to March 1, 1913, the fair market value as of that date, no further allowance shall be made . . . .

Id. § 12, at 769.

[8]Note, *supra* note 2, at 160; 19 OIL & GAS TAX Q. 79, 82-83 (1970).

[9]Ch. 18, 40 Stat. 1057.

[10]In the case of . . . oil and gas wells, . . . a reasonable allowance for depletion . . . according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be in lieu of cost up to that date: *Provided further*, that in the case of . . . oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of discovery, or within thirty days thereafter; such reasonable allowance in all the above cases . . . to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deduction as allowed by this paragraph shall be equitably apportioned between the lessor and lessee.

Id. § 234(9), at 1078-79.

[11]Statement of Professor Reid Hambrick, *Panel Discussions on General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 9, at 1368 (1973).

[12]*Id. See also* H.R. REP. No. 356, 69th Cong., 1st Sess. 31-32 (1925); S. REP. No. 52, 69th Cong., 1st Sess. 17-18 (1925); Note, *supra* note 2, at 161; 18 OIL & GAS TAX Q. 209, 211 (1969); 19 OIL & GAS TAX Q. 79, 83 (1970).

[13]Ch. 27, 44 Stat. 9.

[14]*Id.* § 204(a), at 16.

[15]*Id.* §§ 214(a), 234(8).

added a provision which allowed a deduction for percentage depletion of 27½ percent of gross income not to exceed 50 percent of net income.[16] This percentage was not related in any manner to investment or discovery value of the well.

The basic mechanics of how the change from discovery depletion to percentage depletion occurred merit a short discussion at this point. The Treasury argued that discovery depletion should be available only to those who make actual discovery, thereby encouraging exploration and helping wildcatters.[17] The Treasury Department advocated that cost depletion should be retained and specifically opposed percentage depletion.[18] The oil industry urged that Congress adopt percentage depletion.[19] Thus the Senate attached an amendment to the House bill which had a percentage depletion rate of 30 percent.[20] In conference the figure of 27½ percent was reached as a compromise.[21] The power of the oil industry was highly effective in the Senate, for that chamber originated percentage depletion which made discovery depletion for oil and gas universal.[22]

For nearly two decades (1933-1951), extensive efforts were conducted by each President and his Treasury Department either to eliminate or to reduce substantially the percentage depletion allowance.[23] The legislative response, however, was directly opposed to the executive. Soon nearly every mineral, not just oil and gas, became subject to percentage depletion.[24] Under the 1954 Code, discovery value was supplanted completely by percentage depletion,[25] and the allowance for percentage depletion was extended to clay, gravel, mollusk shells, clam shells, oyster shells, peat, sand, and stone.[26] One writer correctly noted: "Percentage depletion has come a long way from its original purpose of aiding the wildcatter in his search for oil."[27]

B. Present Law

Under the present law there are two methods of computing the

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[16]*Id.* § 204(11)(c)(2), at 16.

[17]H.R. REP. No. 1, 69th Cong., 1st Sess. 6 (1926).

[18]*Hearings on the Revenue Revision of 1925 Before the House Comm. on Ways and Means*, 69th Cong., 1st Sess. 161-64, 197-208 (1925).

[19]*Id.* 147-85.

[20]67 CONG. REC. 3776-78 (1926).

[21]19 OIL & GAS TAX Q. 79, 83 (1970).

[22]Martin, *Percentage Depletion for Oil—Saint or Sinner?*, 9 BAYLOR L. REV. 247, 272 (1957).

[23]J. MERTENS, *supra* note 4, at § 24.04.

[24]*See* INT. REV. CODE OF 1954, § 613(6) [hereinafter cited as CODE].

[25]Statement of Professor Reid Hambrick, *supra* note 11, at 1368.

[26]CODE §§ 613(b)(5)-(6).

[27]Martin, *supra* note 22, at 280.

depletion allowance—cost depletion and percentage depletion.[28] Section 611 merely provides for the depletion allowance; it does not provide the method whereby such "reasonable allowance" is to be computed. The method of computation is set forth in sections 612 and 613.

1. Cost Depletion

Section 612 provides that the basis for cost depletion is the same as that provided for under Section 1011 of the Code which is used in determining the gain or loss on a sale or other disposition of property.[29] Under the concept of cost depletion, a taxpayer is allowed a deduction from his basis in the mineral property in relation to the production and sale of either oil or gas, whichever the case might be.[30] Thus there are three basic criteria which must be known before one can compute the allowable amount of cost depletion: the basis of the property; the estimated total recoverable units in the property; and the number of units recovered during the tax year in question.[31] One authority has said that "cost depletion for tax purposes related the recovery of the taxpayer's investment to the proportion that the current unit sales of mineral products bears to the total anticipated unit sales of products from the property."[32] Obviously these factors relate only to the interest of the taxpayer in the particular mineral property. The regulations describe the method of computing cost depletion as follows:

> After the amount of such basis applicable to the mineral property has been determined for the taxable year, the cost depletion for that year shall be computed by dividing such amount by the number of units of mineral remaining as of the taxable year, and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year.[33]

This method of computation may be expressed mathematically as $B(\frac{S}{U+S})$, where B = Basis (adjusted) of the property at the end of the period;
U = Units remaining at the end of the period;
S = Units sold during the period.[34]

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[28]In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. CODE § 611.

[29]*Id.* § 612.

[30]C. BREEDING, *supra* note 6, at § 8.02.

[31]J. MERTENS, *supra* note 4, at § 24.29.

[32]C. BREEDING, *supra* note 6, at § 8.03.

[33]Treas. Reg. § 1.611-2(a) (1960).

[34]C. BREEDING, *supra* note 6, at § 8.03.

The adjusted basis of the property for purposes of depletion may eventually be zero, ending the use of cost depletion for that particular property. Since the taxpayer must compute his depletion under both cost and percentage, however, and claim the *larger*[35] of the two sums as his "allowable depletion," the taxpayer may continue to claim percentage depletion based upon his income from the property.[36]

It should be noted that cost depletion has not been subject to the criticisms directed toward the concept of percentage depletion. Cost depletion as a tax concept seems eminently correct, for it follows closely the concepts of depreciation and amortization. A basic premise of this article, therefore, is that cost depletion is justified as preventing a tax on invested capital.

2. Percentage Depletion

The computation of percentage depletion is exceedingly simple and straightforward.[37] Under percentage depletion the taxpayer has a deduction of a specified percentage (22 percent for the owner of an economic interest in the oil or gas property)[38] of the gross income.[39] A taxpayer who receives $100,000 in gross income from one oil property in which he has an economic interest and has $50,000 of net taxable income from that property may deduct $22,000 under the concept of percentage depletion. The only limitation on the amount of the deduction is that it may not exceed 50 percent of the taxpayer's net taxable income from the property.[40]

Under the present law the owner of an oil or gas property which originally had a basis of $1 million which was recovered after 10 years

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[35]CODE § 613; *see* Murphy Oil Co. v. Burnet, 287 U.S. 299 (1932).

[36]1941-2 CUM. BULL. 8, *acquiescing in* Louisiana Iron & Supply Co., 44 B.T.A. 1244 (1941). *See generally* CODE § 614 (definition of "property"). The basic premise is that each oil property is to be reduced to the smallest possible part. *See also* Martin, *supra* note 22, at 251.

[37]In the case of the mines, wells and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion) . . . . In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

CODE § 613(a). For the applicable percentage, see *id.* § 613(b).

[38]*Id.* § 613(b)(1)(A).

[39]C. BREEDING, *supra* note 6, at § 8.02. An attempt to explain the inherently difficult terms of "economic interest," "net income," "gross income," "royalties," and "rents" is beyond the scope of this article.

[40]CODE § 613(a).

of production may continue to deduct 22 percent of his gross income from the property as long as such deduction does not exceed 50 percent of his net taxable income from such property.[41] Interestingly, this property owner need not have lifted a hand in drilling the well to receive this deduction.[42] These two factors cause critics to scream "subsidy" and "tax loophole" and urge the abolition of such an anomaly from the tax laws. These cries of inequity versus the exhortations of the oil industry for greater tax "incentives" deserve further study.

C. *Arguments for Percentage Depletion*

One writer noted that he felt bound to give more attention to the material favoring change, because careful examination of all the literature shows clearly that this is an area in which no funds are available to develop the case for change, where virtually no one rises to represent the public generally, and where many voices and great financial resources are behind the oil interests.[43] This is no doubt an accurate statement today, but this of itself should not detract from valid and supportable arguments made in behalf of percentage depletion. Though numerous justifications have been advanced by the proponents of percentage depletion, the four major arguments are: allocative neutrality, national security, return of capital, and incentive for exploration. An analysis of each of these propositions follows. There is special emphasis on the exploration argument, for this would seem to be of immediate concern in view of the energy crisis.

1. Allocative Neutrality

This proposition is advanced by those who believe that the corporate tax structure as presently enforced under the Internal Revenue Code penalizes the oil and gas industry. Their thesis is that a corporate tax would be neutral if it did not affect the allocation of corporate resources needed for expansion of facilities and markets, research and development, and production techniques.[44] It is therefore argued that if a corporate tax is implemented, the tax will be passed on by the industry, the price of the product will rise, and where the rate of return on turnover is higher than average, the supply price will rise at a disproportionate rate.[45] This effect usually occurs in industries with high risk and low capital turnover, a classification into which the oil and gas industry

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[41]*See* note 35 and accompanying text *supra*.

[42]*Id.*

[43]Freeman, *Percentage Depletion for Oil—a Policy Issue*, 30 INDIANA L.J. 399, 400 n.6 (1955).

[44]Davidson, *The Depletion Allowance Revisited*, 10 NATURAL RESOURCES J. 1, 2 (1970).

[45]*Id.*

falls. Certain economists argue that resources are therefore allocated away from such industries because the demand for that product is significantly reduced.[46] How does percentage depletion affect this allocation of capital and resources? If preferential treatment to the oil and gas industry is subsequently passed forward by the industry to its customers, the price remains lower and the demand continues to be strong and consistent.[47] For that reason, one writer urges that percentage depletion has been passed on to the consumer rather than retained as higher profits for the oil industry.[48] In support of this assertion he traces certain statistics which show that in 1920, 5.3 hours of work were required to buy 10 gallons of gasoline, while in 1955 only 1.1 hours of work were needed to buy 10 gallons of gasoline.[49] If the percentage depletion allowance were removed, lost profits would be passed on the consumer, and the price of gasoline would rise.[50] The gasoline prices of 1974 rose because oil companies were able to convince the consumer that their cost of production from a monopolistic supply source (of which each was a participant, to some degree) had risen to such proportions to justify the increase in price. Similarly, if depletion were eliminated, their argument would be the same, and the prices would rise again. Interestingly, so would their percentage of profits.

A second aspect of this argument is illustrated by the following example:

> Suppose two capital assets, one an industrial machine and the other a mineral deposit to which percentage depletion applies. Assume that these two assets are equal in cost and that the streams of income expected from them, before income tax but net of other relevant costs, are equal in present value. With no income tax or with equal effective rates of income tax (implying like schedules of depreciation), the two assets would be equally attractive to rational investors. But with an income tax and percentage depletion as it applies to the minerals in the United States, the effective income tax rate would be lower for the owner of the mineral deposit; because in computing taxable income the owner of the machine would be allowed to deduct as depreciation the cost of the machine only, while the owner of the mineral deposit would be allowed to deduct a percentage of gross income in addition to the costs of finding and developing the deposit.[51]

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[46]*Id.* *See also* McDonald, *Percentage Depletion and the Allocation of Resources: The Case of Oil and Gas*, 14 NAT'L TAX J. 323, 323-36 (1961).

[47]McDonald, *supra* note 46. *See also* Martin, *supra* note 22, at 302.

[48]Martin, *supra* note 22, at 301.

[49]*Id.* 302.

[50]*Id.* 303.

[51]Harberger, *The Taxation of Mineral Industries*, in *Compendium of Papers Presented to the Joint Committee on the Economic Report*, 84th Cong., 1st Sess. (1955), *quoted in* McDonald, *supra* note 46, at 323-24.

Thus the mineral deposit is the more attractive investment and investors put their money into exploring and developing oil and gas reserves. The supply is thereby increased and the price is proportionally lowered. Two benefits are derived from the reallocation of resources to the oil and gas industry—lower prices and increased exploration. This precise argument on behalf of percentage depletion was made to the House Ways and Means Committee in 1959 and resubmitted in written form in 1973 by a spokesman for the oil industry.[52]

Other economists believe that these arguments are overstated and are not particularly valid.[53] Questions arise as to whether the petroleum industry really does shift the benefit of percentage depletion forward to the consumer. It seems more likely, it is argued, that the large lease costs and royalty payments encourage a backward shifting.[54] At least one commentator asserts that the corporate income tax and the depletion allowance have their greatest impact on the size of "after tax economic rents received in the industry," and relatively little impact on resources allocation.[55] Secondly, based upon the continued use of public policies such as proration and import controls which encourage the domestic use of high real-cost wells and limit the production and use of oil from low real-cost facilities, percentage depletion cannot be supported as the answer to the nonneutral corporate income tax.[56] This seems to be a justifiable answer to the assertion that percentage depletion offsets the inequities found in the corporate tax structure.

This was especially true prior to late 1973 and 1974 when the price of Arab oil was much cheaper than domestic oil. Production costs are still much lower. The price rise resulted from the Arabs' belief that they should be making a higher profit per barrel and their belief that they needed an effective foreign policy tool. (It should not be forgotten that the cartel producing oil consists of American and British oil companies.)

This entire argument was succinctly made during the 1973 panel discussions before the House Ways and Means Committee:

> Even if the percentage depletion was a method of achieving tax neutrality, this is not the only goal of public policy. As Steiner . . . stated over 13 years ago: "The central issue of public policy does not concern whether such provisions affect the allocation of resources

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[52]Statement of Richard J. Gonzalez, *Panel Discussions on General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 9, at 1354 (1973).

[53]Davidson, *supra* note 44, at 2-6; Eldridge, *Rate of Return, Resource Allocation and Percentage Depletion*, 15 NAT'L TAX J. 209 (1962); Musgrave, *Another Look at Depletion*, 15 NAT'L TAX J. 205 (1962).

[54]Davidson, *supra* note 44, at 3.

[55]*Id.* 4.

[56]*Id.* 6.

> among industries but rather whether the social benefits are worth the costs involved."[57]

The proponents of percentage depletion argue the costs are worth the advantage; the opponents argue the converse.

2. National Security

Amazingly, one of the perennial arguments in favor of percentage depletion is that the security of the United States would be significantly endangered if percentage depletion were abolished. This argument was summarized by Professor Spann in his statement to the House Ways and Means Committee. He stated:

> In the context of public policy debate and from the history of the development of the depletion allowance, the dominant goal or justification of the depletion allowance appears to be the national security argument. The claim is that extra productive capacity (called reserves) is needed for use in the event of war or other national emergency, and that special tax benefits are needed to encourage the creation of such reserves.[58]

This summary indicates the typical argument regarding "national security" and its relationship to percentage depletion. In 1951 the oil industry was propounding the following argument:

> While percentage depletion stands on its own merits in times of peace, there is, in time of national peril, a further consideration which must not be overlooked and that is the question of whether the country can afford the risk involved in tampering with the percentage depletion provisions of the Internal Revenue Code. . . . In view of the risk factors involved in oil production, any tampering with the percentage depletion allowance at the present time could result in a dwindling of our domestic oil supply like turning down a spigot and the taxes to be derived from the oil industry would likewise decrease.[59]

The argument is that the allowance promotes exploration and the discovery of reserves which would be needed for carrying on a war because "petroleum is not merely a fuel for the vehicles of war but is also the basic ingredient of conventional explosives."[60]

Several fallacies within this argument for percentage depletion

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[57]Statement of Robert M. Spann, *supra* note 1, at 1317, *quoting* Steiner, *The Non-neutrality of Corporate Income Taxation—With and Without Depletion*, 16 NAT'L TAX J. 238 (1963).

[58]Statement of Robert M. Spann, *supra* note 1, at 1316.

[59]Ray, *The Attack on Percentage Depletion*, 2D INST. ON OIL & GAS LAW & TAX. 531, 537-38 (1951).

[60]Note, *supra* note 2, at 163.

have been noted. First, there is no evidence that this country's national security would be endangered by abolition of the percentage depletion allowance since no one has shown that the depletion allowance substantially increases the amount of our petroleum reserves.[61] It would seem that the very nature of this tax concept of depletion would encourage greater production rather than a retention of proven mineral deposits.[62] This is true because depletion is dependent upon production of the mineral deposit not discovery of the deposit.[63] Second, even if the percentage depletion allowance does increase the net amount of petroleum reserves, there is absolutely no indication that this method is the cheapest method of obtaining the necessary production capacities for an adequate defense.[64]

The question, then, is what are the alternatives for providing an incentive for discovery of needed reserves for our national defense other than percentage depletion and what are the costs of such an alternative system. Some commentators have suggested that it is cheaper to buy oil from foreign sources with an intention of instituting a "defense storage reserve" whereby reserves are maintained for a national emergency.[65] It is asserted that national security protection equivalent to that now afforded by the present percentage depletion allowance and import quotas could be purchased by an alternative means at a great tax and revenue savings. The savings allegedly would entail billions of dollars.[66] Savings may no longer be that great, based upon the current price of foreign oil. This argument, however, may now be valid for a related reason. If oil has become so valuable and important to our national security, would it not be prudent to use the oil of other nations and save that which we presently possess? If such is true, tax incentives encouraging the production of foreign oil for our use should be seriously considered with a corresponding negative incentive for production of domestic sources.

The argument that our national security is dependent upon percentage depletion requires one further observation: percentage depletion must encourage exploration. The validity of the exploration argument will be analyzed subsequently, but the dependence is worthy of note at this point; if the exploration argument founders, so does the national security argument.

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[61]Statement of Robert M. Spann, *supra* note 1, at 1316.

[62]Davidson, *supra* note 44, at 6.

[63]C. BREEDING, *supra* note 6, at § 8.01.

[64]Statement of Robert M. Spann, *supra* note 1, at 1316.

[65]Mead & Sorenson, *A National Defense Petroleum Reserve Alternative to Oil Import Quotas*, 47 LAND ECON. 3 (1971).

[66]Statement of Robert M. Spann, *supra* note 1, at 1325.

3. Return of Capital

A third major argument made by the proponents of percentage depletion is based upon the concept that depletion, in reality, allows the oil developer to recover his capital investment free of any tax. The allowance provides a mechanism whereby an oil company is afforded fair treatment for the capital gains realized upon the sale of oil as it is produced. No longer does any doubt exist that a return of capital invested is not to be taxed.[67] In the case of oil and gas, it is argued that the capital recovery is too low under conventional methods and that percentage depletion offsets this by allowing a recovery for the *value* of the mineral deposit rather than its costs.[68] Percentage depletion allows an oil producer to receive a certain percentage of his gross income free of tax under the assumption that these tax-free funds will be used to replace the depleted mineral property.

The argument of the oil industry is that the oil operator is a special case which deserves the significant tax break which he receives since he cannot build a new oil reservoir or plant a new oil crop. Once the oil is removed, production ceases and new oil and gas fields must be discovered. The industry has no product or crop which may be produced annually.

The counterargument is that the oil operator is entitled to the normal return of capital at no tax cost. This return is provided under the concept of cost depletion. Similarly, few have objections to taxing " no more than the *net* income of oil operations,"[69] thereby allowing the oil operator to deduct his losses from his gross income. The objection is raised, however, because the percentage depletion allowance is unrelated to either actual depletion sustained or the aggregate amount invested by the taxpayer in oil production.[70] Interestingly, these arguments were made prior to the adoption of the 1954 Code; the same arguments nevertheless arise today in congressional hearings. Professor Hambrick stated:

> One finds all discussion of percentage depletion for oil and gas stultifying. Any recovery of capital investment in excess of actual outlay is a curious anomaly, without rational support in any known principles of law, accounting, or economics.[71]

A similar observation was made by another critic of the allowance:

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[67]Eisner v. Macomber, 252 U.S. 189 (1920).

[68]Note, *supra* note 2, at 162.

[69]Baker & Griswold, *Percentage Depletion—A Correspondence*, 64 HARV. L. REV. 361, 376 (1951).

[70]*Id.*

[71]Statement of Professor Reid Hambrick, *supra* note 11, at 1369.

> Percentage depletion allows a standard tax deduction of 22 percent of gross income (price times quantity sold) from oil and gas production and results in a reduced effective tax rate for the industry. This is an extraordinary tax benefit because it permits the tax-free recovery of dollar amounts which are far greater than the taxpayer's original investment in the depletable property. This is why the depletion deduction is a *subsidy* and not just a simple mechanism for depreciating the taxpayer's capital investment.[72]

In essence the argument against this idea that the depletion allowance is justifiable as capital gains treatment seems to be that the petroleum industry should be treated like any other industry which provides a product to its customers. Based upon the oil industry's argument, the income a farmer derives from the production of goods for the marketplace should be subject to depletion. The same would apply to a manufacturer.[73] Secondly, the combination of a deduction for intangible drilling costs[74] plus percentage depletion provides most oil producers a deduction far in excess of their costs.[75]

4. Incentive for Exploration

The ultimate reason advanced for percentage depletion always seems to be that without the allowance there would be no incentive for exploration. It is this basic argument which has sustained the concept of percentage depletion through each attempt at abolition. The other arguments are of secondary importance, though they are intertwined. If percentage depletion does provide an incentive for exploration and does, therefore, improve our energy sources, the concept of percentage depletion may be supportable. For this reason and in view of the energy crisis, this particular argument is deserving of close, critical study.

In the 1918 hearings before the Senate Finance Committee, Mr. Norman B. Beecher, Counsel of the Oil Division of the United States Fuel Administration, testified regarding a tax incentive for exploration that the House bill discouraged rather than encouraged the wildcatter because the depletion allowance was based upon his cost of the property and neither upon the post-discovery value nor upon amounts expended in the discovery process.[76] This argument by Mr. Beecher was for the adoption of discovery depletion in the 1918 Act, but it clearly shows that the exploration incentive was a primary factor in the minds of those who

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[72]Statement of Robert M. Spann, *supra* note 1, at 1310.

[73]Baker & Griswold, *supra* note 69, at 377.

[74]Treas. Reg. § 1.612-4 (1965).

[75]Baker & Griswold, *supra* note 69, at 379. See text accompanying notes 103 through 105 *infra* for a discussion of "intangibles."

[76]Martin, *supra* note 22, at 262.

advocated the adoption of something other than cost depletion. Their argument was that production was becoming more and more difficult because the wells were growing deeper and more costly.[77] The Senate agreed with this argument for discovery depletion.[78] Although in 1926 percentage depletion was substituted for discovery depletion in the case of oil and gas, it was thought and argued that the allowance was an incentive for exploration. This argument was also the recurring theme in the efforts to turn back the Roosevelt administration's attempts for change.[79] In 1952 a presidential study group observed that the depletion provisions of the tax system were the vital incentive for oil and gas exploration and that deletion of these provisions would sharply curtail wildcatting and thus cause either an increase in domestic prices or an increase of imported oil.[80] In 1973 Mr. John G. McLean, the Chairman of Continental Oil Company, argued before the House Ways and Means Committee:

> Percentage depletion is a particularly effective incentive since it is success oriented, not effort oriented. Only those who discover energy resources, and thus help our energy situation, receive the benefit. Percentage depletion also recognizes the distinctive nature of extractive industries, and provides a method of capital recovery. It permits a producer to accumulate funds to replace resources being exhausted through production.[81]

Mr. McLean asserted that the reduction of the percentage from 27½ percent in 1969 to 22 percent was a significant contributing factor to the drop in exploratory drilling in 1970 and 1971 and the reduction of reserves in 1971.[82] This decline was approximately 20 percent.[83] It is the oil industry's position that since only 1 in 10 wildcat exploratory wells finds some producible oil and these successes are not always commercially profitable, the percentage depletion deduction offsets this inherently high risk. The industry argues that a reduction in taxes (a raise in the percentage depletion allowance) leads to an increase in cash flow by the oil producers and a higher return on investment. With greater invested capital, the search for oil is substantially bolstered.[84] Therefore

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[77] *Id.* 264.

[78] S. REP. No. 617, 65th Cong., 3d Sess. (1918).

[79] *Cf.* 81 CONG. REC. 5124-25 (1937).

[80] 1 PRESIDENT'S MATERIALS POLICY COMM'N, A REPORT TO THE PRESIDENT ON RESOURCES FOR FREEDOM 35 (1952).

[81] Statement of John G. McLean, *Panel Discussion on General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 9, at 1254 (1973).

[82] *Id.*

[83] Statement of Richard J. Gonzalez, *supra* note 52, at 1341.

[84] Statement of John G. McLean, *supra* note 81, at 1253-54.

expanded exploration leads to more oil reserves and pushes the nation closer to the self-sufficiency now needed.

The body of opinion on whether the differential tax treatment is justified and especially whether exploration is increased is not unanimous by any means. There are those who unequivocally argue that there is absolutely no substance to the claim that percentage depletion increases the amount of exploration. Even if it does, there is substantial doubt that this method is the most effective or the least costly.

One of the major counterarguments in this vein is that the present depletion allowance has its greatest value for currently producing properties since the allowance is dependent on production, not discovery.[85] The main thrust of the provision is to encourage the development and depletion of known reserves rather than the exploration of unknown areas producing unknown results.[86] Second, it is questionable whether percentage depletion is a greater incentive to exploration than the right to deduct intangible drilling costs. A normal manufacturing company is provided neither percentage depletion nor deduction of intangible drilling costs. Yet a manufacturing company may expand even though it is not getting its plant tax-free (that is as an offset to gross income in 1 year). Such a company must depreciate its building over its expected life.[87] It is further argued that exploration and production are reflections of price, technique, and the intangible drilling costs deduction.[88] The question that ultimately arises is whether we want to encourage the extraction of oil, which percentage depletion surely does, when faced with an exhaustible supply of oil.

It has been argued that percentage depletion contains no incentive for exploration; the incentive effect of discovery depletion was abandoned when percentage depletion was adopted.[89] Under the concept of percentage depletion, "anyone receiving a share of income from mineral production by virtue of having a capital interest attributable to the mineral in place is entitled to percentage depletion."[90] The royalty owner who has entailed no financial risk is entitled to the deduction. Further, it has been asserted that the rise of the automobile industry, not the adoption of percentage depletion in 1926, was the needed spur to the growth of the oil industry.[91] Therefore, the retention of the percentage depletion allowance allows, under the present rate of 22 percent,

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[85]Davidson, *supra* note 44, at 6.

[86]*Id.*

[87]CODE § 167.

[88]Freeman, *supra* note 43, at 420. *See also* Eldridge, *Tax Incentives for Mineral Enterprise*, 58 J. POL. ECON. 22 (1950).

[89]Statement of Professor Reid Hambrick, *supra* note 11, at 1369.

[90]*Id.*

[91]*Id.*

the oil industry to recover 16 times more than cost depletion.[92] To these critics, the proponents of this "subsidy" have not justified their position that the deduction provides an incentive for expanded exploration.

5. Revenue Effect

Any discussion of percentage depletion would be incomplete without a brief exposition of the way in which the treasury of the country is affected by the allowance. It is probably impossible to compute all of the revenue the United States Treasury has lost through the concept of percentage depletion. It is nevertheless worthwhile to survey some of the estimates of lost revenue. In 1937 it was estimated the annual revenue loss from percentage depletion compared to cost depletion was $75 million.[93] In 1950 the loss was estimated at $400 to $500 million.[94] In 1953 the estimated loss was more than $700 million.[95] In 1960 the Treasury Department reported that $2.5 billion out of a net operating income of $5.4 billion was free from tax. This allowed 99,000 individuals with gross income of $900 million to pay *no* tax in 1960.[96] The House Ways and Means Committee Report on the Tax Reform Act of 1969 states:

> In recent years the petroleum industry, which reports about 80 percent of all depletion allowances taken on corporate tax returns, has paid taxes to the United States and foreign governments amounting to about 21 percent of taxable net income. This compares with an average tax of over 43 percent paid by manufacturing companies not eligible for various kinds of special tax treatment.[97]

The House estimated that the changes instituted by the Tax Reform Act of 1969 regarding percentage depletion would increase revenue by $425 million in 1970 and by $410 million in 1971.[98] An oil industry spokesman estimated that the reduction of the allowance from 27½ to 22 percent has cost the oil industry $500 million per year.[99]

During the 1973 hearings before the House Ways and Means Committee it was estimated that $2.5 billion annually of tax revenue are foregone due to percentage depletion.[100] It was further determined that during the year 1971 the total tax cost of the excess of percentage deple-

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[92] *Id.*

[93] H.R. Doc. No. 337, 75th Cong., 1st Sess. 4 (1937).

[94] Freeman, *supra* note 43, at 401 & n.8.

[95] *Id.*

[96] Davidson, *supra* note 44, at 9 & n.18.

[97] H.R. Rep. No. 91-413, 91st Cong., 1st Sess. 108 (1969).

[98] *Id.* 109. This estimate was based upon the fact that the percentage rate would be lowered to 20 percent from 27½ percent.

[99] Statement of John G. McLean, *supra* note 81, at 1254.

[100] Statement of Robert M. Spann, *supra* note 1, at 1323.

tion over cost depletion for *all minerals* was $985 million.[101] During these hearings it was estimated that if percentage depletion were abolished, the price of oil would need to rise about 15 percent in order to hold domestic production constant.[102]

III. Intangible Drilling Costs

Even though percentage depletion is probably the most valuable treatment of the oil and gas industry, the right to deduct intangibles currently is surely the second most important facet of the income tax structure affecting oil and gas.[103] It has been suggested that intangibles represent 75 percent of the cost of drilling an oil or gas well.[104] There is little doubt that the cost of drilling and equipping an oil or gas well should be capitalized and added to the value of oil and gas in place as a normal manufacturing firm would capitalize the cost of a new plant and the equipment located therein.[105] In fact most balance sheets and stockholder reports show a capitalization of the costs of a successful well.

A. History of the Option

Like many income tax concepts, the right to current deduction of intangibles has an interesting and informative history, even though the express right to deduct intangibles did not emerge as a statutory right until 1954.[106] It is obvious from the plain wording of the statutory authority for the deduction that Congress felt that the history of the option was important and actually was to be preserved as part of the present right.

The option to deduct or capitalize was first permitted by the Treasury Department in an administrative ruling relating to the Revenue Act of 1916.[107] The option has been continued in modified form since the first

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[101] *Panel Discussions on General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 9, at 1436 (1973).

[102] *Id.* 1439.

[103] Statement of Professor Reid Hambrick, *supra* note 11, at 1365.

[104] *Id.*

[105] *Id. See also* Statement of Robert M. Spann, *supra* note 1, at 1310.

[106] Notwithstanding subsection (a), regulations shall be prescribed by the Secretary or his delegate under this subtitle corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress.

Code § 263(c).

[107] Treas. Reg. 33, § 170 (1917). It is noteworthy that in 1917 when the option was first given, oil and gas companies wanted to capitalize their costs rather than deduct them currently, as they were actually doing, because capitalization increased the amount of cost depletion which could be taken on a particular property.

ruling.[108] Since the right either to deduct currently or capitalize was not a statutorily based option, litigation was sure to arise over whether the ruling was a valid exercise by the Treasury of its rulemaking power. Though there were attempts to challenge the Treasury,[109] these were futile until 1945. In 1945, however, the Fifth Circuit Court of Appeals held the regulations promulgated by the Treasury granting the option invalid.[110] The court reasoned that these expenditures were clearly capital in nature and that the Commissioner had overstepped his authority by providing an option for either capitalization or current deduction.[111] Realizing the significance of the court's holding, a united oil industry petitioned the court for a rehearing. The Fifth Circuit subsequently denied the two requests for a rehearing[112] even though the oil industry had effectively mobilized Congress and obtained a concurrent resolution recognizing the validity of section 29.23(m)(16) of regulation 111 and the option to deduct intangibles currently.[113] Although the Fifth Circuit remained steadfast in its original holding, the Treasury continued to follow its regulation. Finally in 1954 the oil and gas industry successfully lobbied for statutory authority, and the legitimacy of the Treasury's position, held since 1917, was established with authorization for the Treasury to prescribe regulations granting the option.[114]

B. What Are Intangibles?

The regulations define intangible drilling and development costs as any expenditures which are for items with no salvage value and which are "incident to and necessary for the drilling of wells and the preparation of wells for production of oil and gas."[115] These expenditures include wages, fuel, repairs, hauling, and supplies that are used to drill, shoot, or clean the well, or to clear the ground to build roads to the well, or to construct derricks, tanks, pipelines, and other structures necessary for drilling of wells.[116] Expenditures which are for structures for storing and treating the oil and gas and which are not incident to or necessary for the drilling of the well are *not* intangible drilling and development costs.[117]

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[108]*See* Treas. Reg. 118, §§ 39.23(m)-16(a)(1), (b)(1) (1953), *as amended*, Treas. Reg. §§ 1.612-4(a)(1), (b)(1) (1965).

[109]Ramsey v. Commissioner, 66 F.2d 316 (10th Cir. 1933); Sterling Oil & Gas Co. v. Lucas, 51 F.2d 413 (W.D. Ky. 1931).

[110]F.H.E. Oil Co. v. Commissioner, 147 F.2d 1002 (5th Cir. 1945).

[111]*Id.* at 1004-05.

[112]149 F.2d 238 (5th Cir. 1945); 150 F.2d 857 (5th Cir. 1945).

[113]*See* 91 CONG. REC. 7891 (1945).

[114]CODE § 263(c).

[115]Treas. Reg. § 1.612-4(a) (1965).

[116]*Id.*

[117]*Id.* § 1.612-4(c)(1). *See also* Rev. Rul. 70-414, 1970-2 CUM. BULL. 132.

An interesting example of an intangible drilling cost is the cost of transporting, positioning, erecting, and anchoring an offshore drilling platform which is used both for production and drilling. Nevertheless all of the above enumerated costs are considered by the Internal Revenue Service to be intangible costs which may be deducted currently.[118] In an opposite vein, the Service has ruled that the cost of casing cemented in a well-hole is not an intangible drilling cost because it has salvage value, even though the casing can never be used again.[119] How the casing can have salvage value if it cannot be used a second time is never explained. Another incongruity is that the costs of labor for installing tangible equipment in oil and gas wells may be treated as an intangible cost and deducted currently, even though the cost of the equipment itself must be capitalized.[120] This anomaly and others regarding intangibles will be analyzed subsequently in an attempt to tell whether such favorable treatment is required.

C. *Who May Deduct Intangibles?*

Under regulation 1.612-4(a),[121] an operator (one who holds a working or operating interest in an oil or gas property) may elect to deduct paid or incurred intangibles (depending upon whether he is a cash or accrual basis taxpayer) even though under normal accounting procedures these costs would necessarily be capitalized. If no election to deduct intangibles is made, the operator must capitalize them.[122] This election must be made by the taxpayer for the first taxable year in which such costs are incurred. The election is made when the taxpayer deducts such intangibles on his tax return,[123] and the election is irrevocable.[124] If the operator elects to capitalize these expenses, however, he may subsequently elect to deduct the costs of drilling a nonproductive well (dry hole).[125]

It is clear from the regulations that only the owner of the operating rights in a property (owner of the working interest) who has the responsibility of developing the property is accorded the privilege of making the election to either capitalize or deduct intangible costs. The regulations also make it clear that the operating rights may be held in fee or under a lease or contract.[126]

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[118]Rev. Rul. 70-596, 1970-2 CUM. BULL. 68.

[119]Rev. Rul. 70-414, 1970-2 CUM. BULL. 132.

[120]C. BREEDING, *supra* note 6, at § 14.12. *See* Statement of Professor Reid Hambrick, *supra* note 11, at 1366.

[121]Treas. Reg. § 1.612-4(a) (1965).

[122]*Id.* § 1.612-4(d).

[123]*Id.* §§ 1.612-4(d)-(e).

[124]*Id.*

[125]*Id.* § 1.612-4(b)(4).

[126]*Id.* § 1.612-4(a).

One basic limitation regarding who may elect to deduct intangibles does exist, though the limitation is not found in the final regulations promulgated by the Treasury in 1965. This limitation has been the subject of several rulings[127] by the Internal Revenue Service and was, in fact, originally incorporated in the 1960 proposed regulations. Under this concept, defined as "complete payout,"[128] the Service claims that if a taxpayer contributes more capital to the development of the property than required for purchasing his interest in the property, he may deduct that proportion of the intangibles which corresponds to his share of the working interest income during the payout period.[129]

Thus if *X* agrees to drill and equip a well on *Y*'s lease in return for 80 percent interest in the lease, *X* may deduct only 80 percent of his costs as intangibles and would be required to capitalize the remaining 20 percent of his costs to be recoverable through depletion. If, however, *X* becomes entitled to receive all production income and pay all production expenses until the net proceeds from production equal his cost of drilling and equipping the well, then *X* may deduct 100 percent of his costs as intangibles,[130] even though *X* is afterwards entitled to a 60 percent interest in the lease. It is important that these sharing arrangements be carefully structured in order that every item can be recovered in the payout formula or the taxpayer could lose his right to deduct as intangibles the amount he has actually spent developing the well. This Service-imposed limitation should be eliminated by specific statutory enactment as will be subsequently discussed.

D. The Basic Debate Regarding Intangibles

The first criticism leveled against the right to deduct currently intangible drilling and development costs is that such costs should be capitalized since it is clearly recognized that these costs are capital in nature.[131] The supporters of this right argue that current deduction of intangibles is an incentive for exploration.[132] The supporters of the right to deduct intangibles argue further that the loss of the intangible costs deduction would substantially reduce the number of independent operators and thereby reduce the amount of exploratory drilling in the United States.[133]

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[127]Rev. Rul. 71-207, 1971-1 CUM. BULL. 160; Rev. Rul. 71-206, 1971-1 CUM. BULL. 105; Rev. Rul. 70-336, 1970-1 CUM. BULL. 145; Rev. Rul. 69-332, 1969-1 CUM. BULL. 87.

[128]C. BREEDING, *supra* note 6, at § 14.06.

[129]*Id.*

[130]Rev. Rul. 69-332, 1969-1 CUM. BULL. 87.

[131]*See* text accompanying note 105 *supra*.

[132]Statement of John G. McLean, *supra* note 81, at 1255.

[133]*Id.*

In fact, those who support the concept of a deduction for intangibles contend that the amount of total tax dollars is not substantially reduced by permitting the oil companies to take a current deduction. Their argument is that the timing of the tax-dollar payment is what is affected.[134] Under this analysis, exploration is encouraged because the operator is aided by the timing of his tax deduction. The operator has additional dollars which can be used for investment purposes and drilling other wells immediately without waiting a term of years for the recovery of his costs.

Most critics of the deduction recognize that there is great risk involved in drilling an oil well. Their objection to the deduction and their argument against the incentive rationale is basically that no incentive is required for the installation of tangible equipment. This equipment is not needed until the well has been established as a producer. The labor costs attributable to the installation of equipment should not, they claim, be included in the intangible deduction.[135] As long as a taxpayer bears the financial risk of loss for drilling the well, he should be allowed to deduct those costs under the intangible deduction, but only the actual costs of drilling the well.[136]

The second basic criticism of the intangible deduction is that the deduction provides the oil and gas operator a double deduction when combined with the percentage depletion allowance. The double-deduction argument was framed in this manner:

> Thus federal tax law permits deduction of the major cost of acquiring income-producing real estate against ordinary income from any source whatever during the year in which the investment is made. In addition it rewards the taxpayer who is fortunate enough to strike oil or gas with a depletion deduction of 27½ percent of the annual gross income, after rents and royalties, derived from his investment, although the greater part of his capital investment already has been charged against income derived from other sources, and the balance is wholly absorbed by percentage depletion allowable on income derived from the well long before the well is finally exhausted.[137]

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[134]The impact of the difference in accounting treatment can be illustrated for an operator with $100,000 of taxable income and $40,000 of capital who spends $140,000 on a producing well, including $100,000 for intangible development costs and $40,000 for tangible equipment. If the intangible costs are deducted currently for tax purposes, there will be no net taxable income in the first year even though the financial reports capitalize these costs and show a net income of $100,000. In future years the capitalized costs would be charged as an expense against production but there would be no deduction for tax purposes. Statement of Richard J. Gonzalez, *supra* note 52, at 1342-43.

[135]*See* Statement of Professor Reid Hambrick, *supra* note 11, at 1372.

[136]*Id.*

[137]Murray, *Intangible Drilling and Development Costs of Oil and Gas Wells*, 26 TAXES 312, 313 (1948); *see* Statement of Professor Reid Hambrick, *supra* note 11, at 1365.

The critics of the intangible deduction argue that if the deduction is to be allowed, the amount of the deduction should be subtracted from the initial gross income from the property. In actuality, only cost depletion would be allowed until the production of the property equalled the amount of the intangibles claimed as deductions. This would eliminate the double-deduction problem.

IV. Recommendations and Conclusions

It is generally agreed that the country is facing several years of energy problems which can be solved only if we become self-sufficient regarding our energy supplies. What the role of taxation in this national effort should be and how taxation policy may aid in this quest are the subjects for this final section.

A. Percentage Depletion

The historical development of the depletion concept within the income tax law, including the present status of the law, has been noted. The numerous arguments in behalf of percentage depletion have been critically studied in view of the many counterarguments. With this basic study completed, the writer believes a definitive pattern has emerged. As already noted, the prime argument in behalf of the percentage depletion allowance is that it provides an incentive for exploration. Today this is a vital concern; the nation needs to establish substantial new reserves.

If percentage depletion is to be retained, the burden of proving the need of this deduction should fall on the oil industry. The industry should be required to come forward with reliable statistical evidence which indicates that the percentage depletion allowance encourages exploration and that this method is the cheapest, most effective method of achieving the desired purpose. Otherwise the system should be discontinued and alternative means should be found. If rising prices of oil and gas fail to encourage sufficient exploration and discovery (which seems likely), direct subsidies to those oil operators whose primary activity is exploration for, and discovery of, new oil fields should be instituted. This is not a new suggestion, and it has been subject to some criticism.[138] Nevertheless, those who are making the exploration attempts would be directly benefited; this is not now true for percentage depletion. Today an owner of a royalty interest is entitled to percentage depletion, yet he does not participate in the exploration and discovery process. Under the direct subsidy system neither cost depletion nor the right to deduct currently the cost of a dry hole would be affected.

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[138]Baker & Griswold, *supra* note 69, at 364, 366.

The percentage depletion allowance might be an effective mechanism if it were allowed to work in a vacuum, but its effects are overriden by countervailing policies—price regulation of natural gas, import quotas, and the continued support of the Arab oil cartel. The allowance, as presently structured, encourages investment and production of energy sources whose social costs outweigh its value. Production, not conservation, of reserves is its primary effect.

How would elimination affect the oil industry? It seems that the effect, if any, would be slight, for the total value of all tax incentives is $1.3 billion out of a gross revenue of $100 billion or 1.3 percent.[139] This loss of revenue can easily be made up in a price rise which would ultimately be passed on to the consumer. The price rise would also accomplish a secondary purpose, for the consumption of such energy sources would decrease as the result of the price rise.

A better use of tax incentives can be made. It has been suggested that research and development by energy producers can be encouraged through tax incentives.[140] This type of research and development expenditure could improve efficiency and thereby achieve substantial cost-savings which would outweigh the effect of percentage depletion. Secondly, tax incentives can be used to encourage stockpiling of crude oil and the conservation of known reserves. The one drawback of this proposal is that it requires the country to use foreign oil in preference to domestic oil, and the foreign producers may increase their price because of this increased demand.

One final point regarding percentage depletion is apropos. If a free enterprise system is to work it must be uninhibited. The regulation of the price of natural gas is an excellent example. If left alone the price will fluctuate based upon supply and demand. If it is profitable to sell oil and gas, there will be those who will attempt to find more reserves. They will not need the gimmick of percentage depletion.

B. Intangibles

This article, through an analysis of the history and present status of the option to deduct intangibles, has attempted to show that the arguments against percentage depletion are not similar to the criticisms directed against the deduction for intangibles. Neither is the criticism of intangibles as harsh. This is not to say, however, that improvements cannot be made or do not need to be made.

Three specific suggestions regarding the deduction are offered. First, intangibles should be limited specifically to the actual cost of

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[139] *Panel Discussions on General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 9, at 1462 (1973).

[140] *Id.* 1411.

drilling the oil or gas well. The deduction should not include the cost of any tangible equipment which will be used in production or the cost of the labor required to install such tangible equipment. Second, percentage depletion, if retained, should not be allowed until all the intangibles deducted have been recovered from gross income. When these intangibles have been recovered, depletion would begin. This change would prevent the double deduction whereby both the intangible deduction and depletion reduce the amount of taxable income derived from a particular oil and gas property.

Finally, the rules regarding the complete payout concept should be specifically overruled by statute. The new statute should specifically provide that the taxpayer who bore the cost burden of drilling the oil or gas well should be entitled to the intangible deduction.

Mississippi Law Journal

JOURNAL of the MISSISSIPPI STATE BAR and
the UNIVERSITY of MISSISSIPPI SCHOOL of LAW

VOLUME 45 NOVEMBER 1974 NUMBER 5

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COMMENTS

OPEN MEETINGS LAWS: AN ANALYSIS AND A PROPOSAL

I. INTRODUCTION

A contingent of concerned parents and friends of students of the Mississippi School for the Deaf gathered outside the room where the school's governing board was conducting its monthly meeting. The group was awaiting word on whether it would be admitted to the proceeding, during which it was hoped that alleged irregularities at the school would be publicly discussed. After 30 minutes, the board's chairman emerged and said, "I can't give you the board's time." When asked for the results of the vote which closed the meeting, the chairman replied, "We didn't vote on it. We don't have to."[1] Unfortunately, he was correct. The frustrated parents had no effective remedy for being locked out of the meeting, because only a week earlier the 1974 Mississippi Legislature adjourned after killing various attempts by lawmakers to open meetings of governmental bodies to the public in Mississippi.[2] Due to the legislature's failure to act, Mississippi remains one of only four states without open meetings legislation.[3]

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[1]Clarion-Ledger (Jackson), April 12, 1974, at 1, col. 1.

[2]The only floor test of an open meetings bill came on February 4, 1974, when it was moved to suspend the rules in order to remove House Bill No. 123 from the House Rules Committee. The motion, which required a two-thirds vote for passage, was defeated by a vote of 80 to 31. Questionnaire answered by Norma Fields, State Editor, Tupelo Daily Journal, for William R. Wright, May 1974, on file at the *Mississippi Law Journal*. (Questionnaires were submitted to newspaper editors in several states to ascertain their views on open meeting laws. The returned forms are hereinafter cited as Questionnaire. They are on file at the *Mississippi Law Journal*.) Other floor tests involved amendments to various state bills which if passed would have opened only meetings of specific agencies. For example, an amendment to open all meetings of the State Forestry Commission was added to the Forestry Licensing Act, styled as House Bill No. 349. The amendment was narrowly defeated by a vote of 59 to 50. A comprehensive open meetings bill never left the committee stage in the house. Senate Bill No. 1607, however, left the Senate Committee on the Judiciary "A", but being at the bottom of the calendar, never received a floor test. Questionnaire answered by Norma Fields, *supra*. The vote totals appear on copies of "roll calls" available at the Mississippi State Capitol.

[3]The other states are New York, Rhode Island, and West Virginia. The code sections of open meetings laws not in effect are as follows: ALA. CODE tit. 14, §§ 393-94 (1958); ALASKA STAT. §§ 44.62.310-.312 (Cum. Supp. 1973); ARIZ. REV. STAT. ANN. §§ 38.431-.431.06 (Supp. 1973); ARK. STAT. ANN. §§ 12-2801 to -2807 (1968); CAL. GOV'T CODE §§ 11120-31 (West Supp. 1973), 54950-60 (West 1966), *as amended*, (West Supp. 1973); COLO. REV. STAT. ANN. §§ 3-19-1, 123-10-20 (1963), 3-33-1,-2 (Supp. 1973); CONN. GEN. STAT. ANN. § 1-21 (Supp. 1973); DEL. CODE ANN. tit. 29, § 5109 (Supp. 1968); FLA. STAT. ANN. § 286.011 (Supp. 1974); GA. CODE ANN. §§ 23-802, -9912 (1971), 40-3301 to -3303, -9911 (Supp. 1973); HAWAII REV. STAT. §§ 92-1 to -4 (1968); IDAHO CODE § 59-1024 (Supp. 1973); ILL. ANN. STAT. ch. 102, §§ 41-46 (Smith-Hurd Supp. 1974); IND. ANN. STAT. §§ 5-

Why Mississippi is reluctant to remove the veil of secrecy from its governmental bodies is not known. Perhaps state legislators are skeptical of any proposal for governmental reform that has been so enthusiastically endorsed by members of a sometimes unpopular modern press.[4] But what about the public's right to know? Does not the opportunity for the general public to attend meetings override any attempt to counter what public officials may feel is a predacious—albeit free—press?[5]

It is well known that Mississippi lawmakers are skeptical of any proposal that is "liberal" in the context of the classical definition of that

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14-1-1 to -6 (Burns 1974); IOWA CODE ANN. §§ 28A.1-.8 (Cum. Pamphlet 1974); KAN. STAT. ANN. §§ 75-4317 to -4320 (Supp. 1972); KY. REV. STAT. ANN. §§ 87.030, 88.040, 89.550 (1969); LA. REV. STAT. ANN. §§ 42:5-8 (1965), *as amended*, (Supp. 1974); ME. REV. STAT. ANN. tit. 1, §§ 401-06 (1964), *as amended*, ch. 433, § 402, [1973] Me. Acts 522; MD. ANN. CODE art. 23A, § 8; art. 25, § 5; art. 41, § 14 (1957); MASS. GEN. LAWS ANN. ch. 30A, § 11A, ch. 34, § 9, ch. 39, §§ 23A-C (Supp. 1974), *as amended*, ch. 83, § 23C, [1974] Mass. Acts 46; MICH. COMP. LAWS ANN. §§ 15.251-53 (Supp. 1974); MINN. STAT. ANN. § 471.705 (Supp. 1974), *as amended*, ch. 680, §§ 1-4, [1973] Minn. Acts 1548; MO. ANN. STAT. §§ 610.010-030 (Supp. 1974); MONT. REV. CODES ANN. §§ 82-3401 to -3403 (1966); NEB. REV. STAT. §§ 84-1401 to -1405 (Supp. 1971); NEV. REV. STAT. §§ 241.010-.040, 244.080, 268.305, 386.355, 396.100 (1971); N.H. REV. STAT. ANN. §§ 91-A:1-8 (Supp. 1973); N.J. STAT. ANN. §§ 10:4-1 to -5 (Supp. 1974); N.M. STAT. ANN. §§ 5-6-23 to -26 (Supp. 1974); N.C. GEN. STAT. §§ 143-318.1 to .7 (1974); N.D. CENT. CODE § 44-04-19 (1960); OHIO REV. CODE ANN. § 121.22 (Page 1969); OKLA. STAT. ANN. tit. 25, §§ 201-02 (Supp. 1973); ORE. REV. STAT. §§ 192.610-.710 (Supp. 1973); PA. STAT. ANN. tit. 65, §§ 251-53 (1959); S.C. CODE ANN. §§ 1-20 to -20.4 (Supp. 1973); S.D. COMPILED LAWS ANN. §§ 1-25-1 to -4 (1967), *as amended*, (Supp. 1974); TEX. REV. CIV. STAT. art. 6252-17 (1970), *as amended*, (Supp. 1974); UTAH CODE ANN. §§ 52-4-1 to -4 (1970); VT. STAT. ANN. tit. 1, §§ 311-13 (1972), *as amended*, (Supp. 1973); VA. CODE ANN. §§ 2.1-342 to -345 (Supp. 1973); WASH. REV. CODE ANN. §§ 42.30.010-.920 (1972), *as amended*, (Supp. 1973); WIS. STAT. ANN. § 66.77 (Supp. 1973); WYO. STAT. ANN. §§ 9-692.10 to .16 (Cum. Supp. 1973); ch. 442, §§ 1-10, [1974] Tenn. Acts 62.

[4]For the role of the press in the struggle for antisecrecy legislation, see text accompanying notes 35 through 43 *infra*.

[5]It is possible that journalists have been so enthusiastic in their support of open meetings laws that some critics feel that such legislation would benefit only the press. Several members of the press apparently have recognized this problem.

> I do not consider 'open meeting' laws an accommodation for the press. They are an obligation for the public. I think the press is making a major mistake if it projects open meetings as an obligation to the press rather than a right of every citizen.

Letter from John W. Bloomer, Managing Editor, The Birmingham News, to William R. Wright, May 22, 1974, copy on file at the *Mississippi Law Journal*.

> [W]hen [reporters] are shut out of public agencies, it is not just the press, it is the people and the voters who are locked out. Somehow, it is a lot easier for a politician to slam the door on a reporter than it is for him to slam the door on a voter.

Letter from A. B. Albritton, Jr., Managing Editor, South Mississippi Sun (Biloxi-Gulfport), to William R. Wright, May 23, 1974, copy on file at the *Mississippi Law Journal*.

term[6] or that has been enthusiastically endorsed by so-called liberal commentators and politicians, notwithstanding a clear indication that open meetings are also supported by so-called conservative commentators and politicians.[7] Moreover, the "liberal issue" rationale is difficult

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The press, however, is not unanimous in its support of open meeting legislation. One veteran Mississippi reporter observed:

> The failure of the legislature to adopt open meetings measures also stems back to their hometown news media, primarily weekly newspapers who . . . really do not care whether open meetings are held since it would . . . put a greater burden on weekly newspapers whose publishers/editors are often too civicly [*sic*] involved to *want* open meetings or, on the other hand, haven't the staffs to cover such meetings.

Questionnaire answered by Norma Fields, State Editor, Tupelo Daily Journal, May 1974. The editor of a small north Mississippi newspaper recently opposed open meetings in an editorial.

> Governmental bodies just have to get together without the public ear and eye knowing everything that goes into the discussion. Just as a man and wife have to get together at times and make family plans without the ears of the children.
>
> It is really the same thing. But, those at the head are supposed to know a little more about what is going on or has gone on than the general public.
>
> . . . I just can't see much really being accomplished if the doors are thrown open to every Tom, Dick and Harry that wants to put in his two cents worth
>
> It might be a good idea for the public to know what is on the agenda and what is [*sic*] going to be the highlights of the meeting. Then those who have something to say, could write a letter to the president of the group expressing their views. But all open meetings . . . no, it just wouldn't work.

Goolsby, *Closed Door Policy Seems Best,* The Oxford Eagle, July 24, 1974, at 4A, col. 6.

[6]No citation is needed to substantiate the claim that "liberal" politics is not practiced in Mississippi. It is a well-known fact that Mississippians generally do not support any movement for political reform. This writer is not being critical of conservative politics but is only pointing out how the political climate could be the basis for reluctance on the part of the Mississippi Legislature to pass open meeting legislation.

[7]Labeling individuals as being either "conservative" or "liberal" is risky; this writer is therefore hesitant to do so. A list of individuals and their comments, which hopefully covers the political spectrum from conservative to liberal, will afford the reader the opportunity of making his own subjective assessment of the political persuasion of those who favor open meetings. In 1967, the campaign headquarters of former Mississippi Governor Ross Barnett, who was again running for the office, released the text of his remarks as delivered to the Mississippi Chapter of Sigma Delta Chi, a select national fraternity of journalists. Concerning his views on "freedom of information," Barnett said: "The people of Mississippi certainly have a right to know what is going on in their state government . . . ." In referring to an open meetings law for Mississippi, Barnett said he would sign into law any acceptable " 'freedom of information' bill . . . approved by the legislature." He commented that he believed that Mississippians "have the right to be informed of the actions of their elected and appointed officials." Press release from Barnett for Governor Headquarters, March 17, 1967, copy on file at the Times-Picayune Press Room, Mississippi State Capitol. In reference to the meetings of the Mississippi Board of Trustees of Higher Learning, Mississippi Governor William Waller said he would rather see the board open its meetings which had traditionally been closed. "Secrecy creates suspicion," said Waller. He further remarked that the board members were responsible

to reconcile with the fact that Mississippi's sister state of Alabama has been credited with the first state open meetings law[8] and that "liberal" New York remains one of the four jurisdictions without such legislation.[9]

There are probably critics who feel that government can perform more efficiently in confidence. With open meetings legislation, however, the need for secrecy in certain situations can still be accommodated through built-in exceptions common to most access laws.[10]

A final reason—one which hopefully has little validity—is that state officials are reluctant to make known acts of malfeasance, misfeasance, or, most importantly, dishonesty.

The reasons suggested are only speculative; the purpose of this comment is not to reach a conclusion as to why Mississippi does not have open meeting legislation. Instead, this writer will attempt within a limited scope to examine the arguments for such laws, and to look at the experience of other states with regard to open meetings laws. To put the topic in perspective, the open meetings rationale and its historical and constitutional background will be examined; then the basic provisions of existing open meetings laws will be analyzed in terms of their relative strengths and weaknesses. Finally, the focus of this comment will return to Mississippi with proposed open meetings legislation based

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to the people who had the right to know how the public's business was being conducted. Clarion-Ledger (Jackson), June 28, 1974, at 1, col. 4. "The people's right to know what goes on in government is one of the most basic principles in a free democratic society. I think it is time we moved to guarantee that right to the citizens of Mississippi." Statement accompanying letter from Lt. Gov. William Winter to William R. Wright, May 28, 1974, copy on file at the *Mississippi Law Journal.* Woodrow Wilson, in a 1913 comment about legislative secrecy, said: "It has got to be put in the heads of legislators that public business is public business." W. WILSON, THE NEW FREEDOM 131 (1913). "It is just this simple—when public agencies are dealing with public tax dollars—the tax payers have a right to know how it is being spent." Letter from A. B. Albritton, Jr., Managing Editor, South Mississippi Sun (Biloxi-Gulfport), to William R. Wright, May 23, 1974, copy on file at the *Mississippi Law Journal.* John Gardner, Chairman of Common Cause, once remarked: "Doing the public's business in secret severs the link of accountability between the elected official and his constituents." Gardner, *Government of the* ____, *by the* ____, *and for the* ____, N.Y. Times, Nov. 25, 1972, at 31, col. 2. "Just as there is no such right as an official right to lie to the people, there is no official right to withhold or cover-up official deliberations and actions." Questionnaire answered by Hodding Carter III, Editor, Delta-Democrat Times (Greenville), June 1974. Finally, James Madison once said: "A popular Government, without popular information, or the means of acquiring it, is but a Prologue to a Farce or Tragedy; or perhaps both." 9 THE WRITINGS OF JAMES MADISON 103 (Hunt ed. 1910).

[8]ALA. CODE tit. 14, §§ 393-94 (1959) (enacted 1915).

[9]One New York commentator said that his state shares with some other jurisdictions the "shoddy distinction" of not having an open meeting law. Stein, *Government of the* ____, *by the* ____, *and for the* ____, N.Y. Times, Nov. 25, 1972, at 31, col. 4.

[10]See notes 87 through 91 & 143 through 177 and accompanying text *infra* for a discussion of the exceptions.

on the best—and, hopefully, eschewing the worst—to be found in the 46 existing state open meetings laws.

II. Background and Development of Open Meetings Laws

A. Open Meetings on the National Level

The scope of this comment extends primarily to state open meetings legislation. The struggle for open government, however, began on the national level in common-law England and later in colonial America.

Long before the birth of the United States, access to Parliamentary proceedings was denied because members feared reprisal from the Crown for statements made during floor debate.[11] This fear subsided in the late 17th century, but members continued to meet in secret so that their constituencies would not be aware of unfaithful representation.[12] Despite numerous resolutions passed by both houses of Parliament from 1694 to 1698 for the purpose of preventing reports of Parliamentary proceedings, English writers skirted the rules by publishing accounts of ostensibly imaginary political bodies in such a manner that it was obvious to their readers that actual proceedings were being reported. To halt the leaks, the House of Commons in 1738 declared that such writings constituted a breach of Parliament.[13] Nonmembers continued to be barred from Parliamentary proceedings; however, as time passed, enforcement of the resolutions became lax, and the rule excluding strangers was gradually succeeded by the *custom* of admitting certain members of the press, not as a matter of right, but as a matter of grace.[14] Even in the late 18th century, the public could be denied access to Parliamentary proceedings by request of a single member of the House. Since 1874, however, the public has not been excluded except by a majority vote of the House of Commons.[15] Today Parliament encourages rather than suppresses public reports of its proceedings.[16]

English rulers extended legislative secrecy to the American colonies

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[11]H. Cross, The People's Right to Know 180 (1953) [hereinafter cited as Cross]; F. Thayer, Legal Control of the Press, § 9, at 27 (1950 3d ed.); J. Wiggins, Freedom or Secrecy 4 (1956) [hereinafter cited as Wiggins].

[12]The rules which had been originally designed to secure faithful representatives against the displeasures of the Sovereign, now operated to secure unfaithful representatives against the displeasures of the people, and proved much more effectual for the latter than they had ever for the former.

3 T. Macaulay, The History of England 543 (1915), *quoted in* Wiggins 4.

[13]L. Hanson, Government and the Press 1695-1763, at 32 (1936).

[14]Cross 181-82; F. Thayer, *supra* note 11, at 27-33.

[15]Cross 181.

[16]Note, *Open Meeting Statutes: The Press Fights for the "Right to Know,"* 75 Harv. L. Rev. 1199, 1203 (1962).

and gave legislatures the right to prevent the press from reporting proceedings and debates; secrecy in government was among the controversies leading to the American Revolution.[17] Attitudes in the colonies slowly changed; American governments adopted the view of the New York Assembly that suppression of published accounts of legislative proceedings violated the rights and liberties of the colonist.[18] Early Americans fully supported this view, and were critical of the secrecy in which the Constitutional Convention was conducted.[19] The initial meeting of Congress under the 1788 Constitution was held in March of 1789 with the Senate meeting behind closed doors and the House meeting in public. The Senate did not open its doors until 1794,[20] but today the debates and votes of both houses, as a rule, are open to the public. Most major Congressional decisions, however, are reached in committee meetings, which are not always open to the public.[21] Prior to the passage of the Legislative Reorganization Act of 1970,[22] congressional committees could enter into executive or closed sessions by mere consensus of the committee, or by a committee chairman's declaration that a meeting would be closed. Since the Act's passage, a majority vote of a committee or subcommittee is required to close a session to the public.[23] The Act's effectiveness is lost, however, if a committee votes at its initial session to close every session for the rest of the year.[24] In the first few months of 1974, the United States House of Representatives opened 88 percent of its committee "mark-up" sessions,[25] compared to 80 percent in 1973.[26] The increased number of open meetings has been largely at-

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[17]F. THAYER, *supra* note 11, at 33.

[18]WIGGINS 8-9. The New York Assembly passed the following resolution in 1747:

> [I]t is the undoubted right of the people . . . to know the proceedings of their representatives in General Assembly and that any attempt to prevent their proceedings being printed . . . is a violation of the rights and privileges of the [Colonists].

Id. 9.

[19]*Id.* "The doors were . . . closed, a solemn pledge of secrecy was laid on the members, and thenceforth for many years what took place in the Convention was never fully known." J. MCMASTER, THE POLITICAL DEPRAVITY OF OUR FOUNDING FATHERS 112 (1964).

[20]F. THAYER, *supra* note 11, at 33-34.

[21]COMMITTEE ON THE OFFICE OF ATTORNEY GEN., NAT'L ASS'N OF ATTORNEYS GEN., LEGISLATION CONCERNING THE CORRUPTION OF PUBLIC OFFICIALS 27 (1974) [hereinafter cited as COMMITTEE ON THE OFFICE OF ATTORNEY GEN.].

[22]Pub. L. No. 91-510, 84 Stat. 1140 (codified in scattered sections of 2, 5, 8, 31, 40 U.S.C.).

[23] 2 U.S.C. § 190a(b) (1970).

[24]L. GILSON, MONEY AND SECRECY 19-20 (1972) [hereinafter cited as GILSON].

[25]A "mark-up" session is a proceeding during which a committee does the actual drafting of bills to be voted upon and sent to the full House of Representatives.

[26]COMMON CAUSE, REPRESENTATIVES VOTING RECORDS ON CLOSED COMMITTEE MEETINGS 1 (1974) [hereinafter cited as COMMON CAUSE]. The Common Cause study included statistics as to how various Representatives voted on the issue of whether a committee

tributed to a 1973 House rule requiring the votes of each committee member to be made public on a motion to close a session.[27] The Senate, on the other hand, has no antisecrecy rule, and most committee meetings continue to be shrouded in secrecy.[28]

Information about operation of the executive branch of the federal government is not generally obtainable through attendance at open meetings but rather, to a limited extent, through records made available to the public by each agency as provided by the Freedom of Information Act.[29] The Act lists several categories of materials that are available to the public[30] but also lists so many categories of information which may be kept secret[31] that federal agencies meet behind closed doors with little difficulty.[32] It should be emphasized, however, that the federal executive branch is a very complex body within which secrecy is more readily acceptable for the purpose of operational efficiency than is true on the state level. The problem of implementing the open meetings principle in the context of agency proceedings is hampered by problems peculiar to national government; a paramount problem is the requirement of secrecy in the conduct of national defense and foreign affairs. As the Watergate tragedy reveals, however, these very valid rationales for secrecy appear to have been considerably abused. Their employment surely should be a matter of exception, not rule.[33] Confidentiality is necessary in discussions of many fiscal matters, the premature disclosure of which could be economically unsettling, or could aid speculation. Counterbalancing these necessary exceptions to open government, however, are opportunities secrecy affords special interest groups to influence agency officials. Furthermore, in many instances, administrative officials wield what is in effect legislative power delegated by Congress; just as in the case of congressional committee meetings, the people should have access to proceedings where laws and rules affecting

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mark-up session would be closed to the public. Only three Mississippi Congressmen had the opportunity to vote for or against closing a meeting between March 7, 1973, and May 16, 1974. Each time they voted in favor of secrecy. Representatives Bowen, Montgomery, and Whitten voted 7, 19, and 30 times respectively. *Id.* 4.

[27]H. R. Res. 272, 93d Cong., 1st Sess., 119 CONG. REC. 1429 (1973).

[28]COMMON CAUSE, *supra* note 26, at 1.

[29] 5 U.S.C. § 552 (1970); COMMITTEE ON THE OFFICE OF ATTORNEY GEN., *supra* note 21, at 28. "A loophole in the Freedom of Information Act [makes] public access to meeting[s] . . . impossible." Gardner, *Introduction* to GILSON at 7.

[30]*E.g.*, organizational structure, rules of procedure, statements of policy, and records of agency voting. 5 U.S.C. § 552(a) (1970).

[31]*E.g.*, national security matters, internal practices, trade secrets, personnel and medical files, and inter-agency and intra-agency files. 5 U.S.C. § 552(b) (1970).

[32]GILSON 12.

[33]*See* Emerson, *The Danger of State Secrecy*, THE NATION, March 30, 1974, at 398-99.

millions of people are discussed and adopted. Perhaps in recognition of the tremendous administrative problems involved in establishing open meetings guidelines for federal agencies, supporters of open government laws have concentrated their efforts on gaining access to public records and documents, an area of great controversy, but too broad to be covered within the scope of this comment.[34]

B. *Development of State Laws*

The development of state open meetings laws has been a phenomenon of the past quarter-century[35] with members of the press playing the most influential role in promoting access legislation.[36] By 1950 newspapermen had become disgruntled by the increasing frequency with which public officials were denying the press admittance to meetings of public bodies.[37] As a remedial measure, the American Society of Newspaper Editors created the Committee on Freedom of Information.[38] While newspapermen were, of course, personally frustrated by being denied access to public proceedings and records, their primary reason for combating secrecy was said to be the recognition of their duty to stand for the public, keeping public officials in the public eye.[39] At the time of the committee's creation, only Alabama had enacted a modern open meetings law;[40] 46 are in effect today.[41] To illustrate the strong pattern of recent legislative activity, note that by 1959 there were 20 state open meetings laws, by 1962 there were 28,[42] and 9 laws have been enacted in the past 2 years.[43]

III. Rationale of the Open Meetings Principle

The most compelling reason for the adoption of open meetings laws

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[34]See Cross for a comprehensive discussion of access to public records.

[35]*See* Freedom of Information Center, Pub. No. 86, Access Laws: Development 1-2 (1962).

[36]Note, *supra* note 16, at 1199.

[37]Pope, *Foreward* to Gilson at vii.

[38]*Preface* to Gilson at xiv.

[39]*Id.* at xiii-xiv.

[40]The brief Alabama law, passed in 1915, is not applicable to the state legislature; however, it covers boards and commissions that disburse public funds, as do many of the more recent laws. Ala. Code tit. 14, § 393 (1959). For a discussion of the coverage provisions of the various laws, see text accompanying notes 82 through 94 *infra*.

[41]*See* note 3 *supra*.

[42]Freedom of Information Center, *supra* note 35, at 1-2.

[43]The states of Georgia, Kansas, Missouri, Nebraska, North Carolina, Oregon, South Carolina, Washington, and Wyoming passed laws during 1972 and 1973. The code sections are cited at note 3 *supra*. Recent legislation is attributable in part to the work of Common Cause, the national citizens' lobbying organization, which has included open meetings legislation as one of the areas of governmental reform which the group has aggressively supported.

is "to enable the people to know what their agents are doing. That really is the essence of it. There need not be any other reason."[44] This succinct statement of the open meetings rationale encompasses the basic premise which supporters of open meetings legislation espouse: The right of the public to participate in a democratic society includes the right to be informed.[45] Our government operates not for the politician but for the people. Through open meetings citizens theoretically are able to participate in their destinies and to govern themselves; these concepts are fundamental to democracy.[46]

Open meetings advocates speak in terms of the public "right" to attend meetings. Is there in fact such a right? As we have seen, the public has no common-law right to attend meetings of public bodies.[47] Many open meetings proponents have stated that access to public information is a right guaranteed by the Constitution.[48] One view is that the freedoms of speech and press have as their purpose the prevention of governmental interference with the dissemination of the facts and views of governmental affairs.[49] "It is obvious that the freedom of the press implies the right to gather news and the right of those who possess information to impart news."[50] Another viewpoint recognizes that the Constitution does not give the public the right of access, but neither does it specifically deny access; therefore, the ninth amendment provision reserving to the people rights not enumerated elsewhere encompasses freedom of access.[51] A final argument for a constitutional basis for freedom of access is based on the fifth and fourteenth amendments due process clauses, which have been applied most frequently to judicial proceedings. As a rule, due process forbids the use of secret information where a court is deciding the fate of specific individuals or organizations.[52] It is argued that due process principles ought to be similarly extended to decisionmaking on a collective scale, as the actions of governmental bodies directly affect the lives of citizens. Access to the facts by interested parties is as necessary in public proceedings as in judicial

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[44]Questionnaire answered by Henry MacLeod, Managing Editor, The Seattle Times, May 1974.

[45]Wickham, *Let the Sunshine In! Open-Meeting Legislation Can Be Our Key to Closed Doors in State and Local Government*, 68 NW. U.L. REV. 480, 481 (1973).

[46]Questionnaire answered by Robert B. Liming, Governmental Affairs Staff, The State (Columbia, S. C.), May 26, 1974.

[47]*See* text accompanying notes 18 through 28 *supra*.

[48]*See generally* CROSS 229-47; WIGGINS 66-91; Parks, *The Open Government Principle: Applying the Right to Know Under the Constitution*, 26 GEO. WASH. L. REV. 1, 6-13 (1957).

[49]Parks, *supra* note 48, at 9.

[50]*Id.* 10.

[51]*See* F. THAYER, *supra* note 11, § 30, at 178. The ninth amendment states: "The enumeration in the Constitution, of certain rights, shall not be construed to deny or disparage others retained by the people." U.S. CONST. amend. IX.

[52]Emerson, *supra* note 33, at 397.

proceedings.[53] In fact, the ramification of action taken by a local school board will have a much greater effect among the citizenry than would the trial of an individual.

No case, however, has been found in which the United States Supreme Court has held that the right to attend meetings of public bodies is guaranteed by the Constitution. Even if the Court so ruled, the right, like the freedom of speech, could not be absolute.[54] Thus, the right to attend public meetings is best established through open meetings legislation.[55]

As indicated, the constitutional arguments in themselves are not effective in supporting open meetings legislation. More persuasive are the many pragmatic considerations. A fundamental argument is that public awareness of the deliberations upon which public action is based is essential to our democratic form of government.[56] Under our political system, the people must be informed of key governmental information in order to make intelligent judgments on questions of policy and to select representatives.[57] A democracy without an informed public is a "contradiction in terms."[58] "[T]he people are the masters and government is the servant, and it is incongruous that the master should be denied the information upon which to direct the activities of his servants."[59] An elementary example concerns the quasi-contractual right of taxpayers to know how their money is being used by public officials.[60] Considering the tremendous tax burden on the public and the resulting increase in the size of Government, that right is more important than ever before. Where the public is able to witness the deliberations which lead to the expenditures of large sums of tax dollars, the misappropriation of funds either by imprudence or dishonesty can be best controlled.[61]

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[53]*See Id.* 395.

[54]The Supreme Court has consistently recognized that there is no absolute right to free speech. *E.g.*, Dennis v. United States, 341 U.S. 494 (1951).

[55]*See* Note, *supra* note 16, at 1204. For a discussion of the exceptions, see notes 87 through 91 & 143 through 177 and accompanying text *infra*.

[56]*See* F. THAYER, *supra* note 11, § 29, at 162; Emerson, *supra* note 33, at 395; Wickham, *supra* note 45, at 481; 46 CHI.-KENT L. REV. 207; Vicksburg Post, Feb. 10, 1974, at 4, col. 1. "The people's right to know what goes on in government is one of the most basic principles in a free democratic society." Statement accompanying letter from Mississippi Lt. Gov. William F. Winter to William R. Wright, May 28, 1974, copy on file at the *Mississippi Law Journal*.

[57]Note, *supra* note 16, at 1200-01.

[58]Questionnaire answered by Hodding Carter III, Editor, Delta-Democrat Times (Greenville), June 1974.

[59]Emerson, *supra* note 33, at 395. "After all the government is for the people and not for the politician." Questionnaire answered by Robert G. Liming, Governmental Affairs Staff, The State (Columbia, S.C.), May 1974.

[60]*See* CROSS 15-16; WIGGINS 19.

[61]*See* Yankwich, *Legal Implications of, and Barriers to, the Right to Know*, 40 MARQ. L. REV. 3, 35 (1956).

Another basic example is that during a period of maximum public distrust of government, open meetings can contribute to the rebuilding of public confidence. Confidence in government is necessary for the successful administration of public business.[62] Suppression of information leads to deception which, after the truth finally comes to light through leaks or efforts of the press, contributes to a credibility gap between politicians and the people.[63] The resulting suspicion[64] increases the feeling of the people that things are being hidden from them, about which they have the right to know.[65] Fortunately, it is believed that most government officials are honest and have public service as their primary aim; but for those public officials who seek to enrich themselves at the expense of the taxpayers, "[i]t would be difficult [for them to find] a more efficient ally of corruption than secrecy."[66] There is a symbiotic relationship between secrecy and evil in government. Corrupt practices are kept confidential because they are wrong, and the wrongs are made possible through secrecy.[67]

Public officials should not have the attitude that only their views should be considered in the decisionmaking process. If meetings are closed, there can be no criticism by the public or the press. Thus, valid points of view never reach those who should respond to public opinions and attitudes. "The light of day on all subjects can lead to other thinking which may be clearer thinking . . . . [W]ithout controversy, only one side of an issue is likely to be explored . . . ."[68] Furthermore, public

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[62]Confidence in government at all levels is at one of the lowest points in history. I think this is at least in part because the public realizes it is being systematically excluded from the decision making process. Public trust won't be restored until government officials rekindle public confidence by being more open. I think a solid open meetings bill is essential to the building of a climate of trust in government in Mississippi.

Questionnaire answered by Robert McHugh, Executive Editor, The Daily Herald (Biloxi-Gulfport), May 1974.

[63]Emerson, *supra* note 33, at 395-96.

[64]*See* The Clarion-Ledger (Jackson), June 28, 1974, at 1, col. 4 (comments by Mississippi Governor William Waller in support of open meetings).

[65]Vicksburg Post, Feb. 10, 1974, at 4, col. 1.

[66]Warren, *Governmental Secrecy: Corruption's Ally*, 60 A.B.A.J. 550 (1974). The late Chief Justice Earl Warren stated:

> When secrecy surrounds government and the activities of public servants, corruption has a breeding place . . . . The minimum amount of secrecy needed for the operation of government should be fixed by law, and no secrecy beyond that point should be countenanced.

Id. "The closed door, of course, permits opportunities for the unscrupulous government officials to indulge in graft, corruption and unethical practices." Questionnaire answered by David E. Halvorsen, Asst. Managing Editor, Chicago Tribune, June 11, 1974.

[67]Emerson, *supra* note 33, at 396.

[68]Questionnaire answered by Warren Koon, Editor, Natchez Democrat, May 1974. Open proceedings enlist the intelligence of the whole community in the lawmak-

proceedings prepare the public to accept unpopular but necessary measures taken for the benefit of the public at large.[69]

Perhaps because all but four states have open meetings laws, contemporary arguments by commentators in opposition to such laws are virtually non-existent; the issue is dead in most areas. Moreover, no open meetings law has yet been repealed, except to be strengthened, and politicans are not likely to attack legislation that has proved successful. Nevertheless, several potent arguments in favor of closed meetings remain current. First, open meetings might provide a stage for public officials to grandstand for the benefit of constituents, perhaps leading to prolonged unproductive meetings. There is also strong feeling that reputations should be protected when citizens are being considered for employment or employees are being reprimanded for poor performance. Additionally, all men desire to avoid being placed in the public eye for fear of appearing ignorant or foolish.[70] Thus, the argument is made that there is less than a full airing of various viewpoints when a meeting is open to the public.[71] There is at least a possibility that the meeting will be reported inaccurately or will be tainted with the reporter's political bias.[72] These arguments are persuasive, as no doubt are others not mentioned here; but almost every state has apparently considered them subordinate to arguments in support of open government. Where the arguments for secrecy are strong, exceptions to open meetings laws have been enacted to accomodate public officials where necessary.[73]

IV. Analysis of State Open Meetings Laws

A. *Declarations of Legislative Intent and Public Policy*

Perhaps the most vital provision in an open meetings law is a statement evidencing a clear, presumptive purpose of the legislature to open the deliberations and actions of government to the people.[74] Several

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> ing process. If a [public official] . . . makes an error in the statement of a premise in an open meeting, the community to which the proceedings are reported surely will have some citizen with the specialized knowledge to perceive the mistake. If the meeting be secret, errors of premise and conclusion may be gathered into a measure without discovery, and on final disclosure it may be too late or too difficult to make needed corrections.

WIGGINS 19-20.

[69]WIGGINS 20.

[70]FREEDOM OF INFORMATION CENTER, *supra* note 35, at 2.

[71]*See* Note, *supra* note 16, at 1202.

[72]*See id.*

[73]See discussion of the exceptions at notes 87 through 91 & 143 through 176 and accompanying text *infra*.

[74]Wickham, *supra* note 45, at 488.

state open meetings laws commence with such statements.[75] Generally, these declarations reflect traditional antisecrecy philosophies:[76] The people have a right in a self-governing society to know how the affairs of their government are being conducted; and without an informed electorate, government cannot perform effectively.[77]

One of the most definitive and effective statements of intent to open government was made by the legislature of the State of Washington.

> The legislature finds and declares that all . . . public agencies of this state and subdivisions thereof exist to aid in the conduct of the people's business. It is the intent of this chapter that their actions be taken openly and that their deliberations be conducted openly.
>
> The people . . . do not yield their sovereignty to the agencies which serve them. The people, in delegating authority, do not give their public servants the right to decide what is good for the people to know and what is not good for them to know. The people insist on remaining informed so that they may retain control over the instruments they have created.[78]

Other statutes emphasize the importance of open government in a democratic society[79] and direct that their open meetings law be construed liberally.[80] Such provisions make clear to public officials that no attempt should be made to limit the coverage of open meetings laws by searching for loopholes. Furthermore, strong declarations of intent will aid the courts by establishing that openness is the policy guideline in resolving individual disputes.[81]

B. Coverage Provisions

1. Public Bodies Excluded from Coverage

While the purpose of open meetings legislation is to remove the veil of secrecy surrounding the transaction of governmental business,[82] legislatures in some instances have defeated this purpose by exempting certain public bodies from open meetings laws through specific language or through narrowly drawn laws.[83] Some of the most hypocritical stat-

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[75]*E.g.*, CAL. GOV'T CODE § 54950 (West 1966); ILL. ANN. STAT. ch. 102, § 41 (Smith-Hurd Supp. 1974); NEV. REV. STAT. § 241.010 (1971); N.C. GEN. STAT. § 143-318.1 (1974); WASH. REV. CODE ANN. § 42.30.010 (1972).

[76]FREEDOM OF INFORMATION CENTER, PUB. NO. 87, ACCESS LAWS; COMPARISON 1 (1962).

[77]*See Preface* to CROSS at xiii; W. LASSITER, LAW AND PRESS 128 (1956).

[78]WASH. REV. CODE ANN. § 42.30.010 (1972).

[79]*E.g.*, S.C. CODE ANN. § 1-20 (Supp. 1973).

[80]*E.g.*, MONT. REV. CODES ANN. § 82-3401 (1966).

[81]Wickham, *supra* note 45, at 490.

[82]*See Introduction* to GILSON at ix.

[83]One writer suggests that the Illinois law which exempts the General Assembly from the act, ILL. ANN. STAT. ch. 102, § 42 (Smith-Hurd Supp. 1974), is a " '[d]o as I say and not as I do' " provision. 46 CHI.-KENT L. REV. 207, 211 (1969).

utes specifically exclude legislatures and legislative committees.[84] Since most far-reaching decisions are made at the committee level, it is unfortunate that some legislatures have chosen to retain the option of locking committee room doors but have paradoxically passed laws requiring other public bodies to meet in the open. Sessions of the legislatures as a whole are generally open by virtue of legislative rule, custom, or separate statute.[85]

There are certain bodies that should *not* be bound by a per se open door rule because the nature of their activity requires confidence. Several legislatures have applied a balancing test in specifically exempting certain bodies by determining that the need for secrecy outweighs the public interest in gaining access to deliberations.[86] Frequently cited as falling outside state acts are parole and pardon boards.[87] A requirement that would open the sensitive discussions of a prisoner's personal affairs and behavior to the public would serve no legitimate purpose and could cause further embarrassment and humiliation to those involved. Also, very strong arguments can be made for giving the prerogative of meeting behind closed doors to law enforcement agencies,[88] military organizations,[89] and public hospital staffs.[90] Some statutes exempt the proceedings of the judiciary from the openness requirement.[91] This seems justified since in the case of criminal trials, public proceedings are required by the federal constitution[92] and also in most states by state constitution or separate statute.[93] Other judicial proceedings are generally open to the public except where the subject matter of a case is such that all but the necessary parties and court officials are excluded by statute or court discretion.[94] In recognition that the courts are not the type of

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[84]*E.g.*, ILL. ANN. STAT. ch. 102, § 42 (Smith-Hurd Supp. 1974); LA. REV. STAT. ANN. § 42:7 (Supp. 1974), *amending* LA. REV. STAT. ANN. § 42:7 (1965); N.J. STAT. ANN. § 10:4-4(e) (Supp. 1974).

[85]*See* GILSON 87, 122.

[86]Wickham, *supra* note 45, at 486.

[87]*E.g.*, ALASKA STAT. § 44.62.310 (Cum. Supp. 1973); ILL. ANN. STAT. ch. 102, § 42 (Smith-Hurd Supp. 1974); N.C. GEN. STAT. § 143-318.4 (1974); OHIO REV. CODE ANN. § 121.22 (Page 1969).

[88]*E.g.*, N.C. GEN. STAT. § 143-318.4 (1974).

[89]*E.g.*, IOWA CODE ANN. § 28A.6 (Supp. 1974).

[90]*E.g.*, ALASKA STAT. § 44.62.310(d)(4) (Cum. Supp. 1973).

[91]*E.g.*, HAWAII REV. LAWS § 92-1(1) (1968); N.J. STAT. ANN. § 10:4-4(e) (Supp. 1974); WASH. REV. CODE ANN. § 42.30.020 (1972). Some statutes also exclude nonjudicial bodies acting in a quasi-judicial capacity. But in Canney v. Board of Pub. Instruction, 278 So. 2d 260 (Fla. 1973), *rev'g* 231 So. 2d 34 (Fla. Dist. Ct. App. 1970), the court held that although a school board considering the suspension of a student who violated hair regulations was acting in a quasi-judicial capacity, the board was part of the legislative branch of government and therefore within the sunshine law's coverage.

[92]U. S. CONST. amend. VI.

[93]CROSS 156-57. Mississippi guarantees the right to public trial in its constitution. MISS. CONST. art. 3, § 26 (1890).

[94]CROSS 163-75.

public institutions whose meetings are intended to be covered by open meetings legislation, no further reference to judicial proceedings will be made in this comment.

2. Public Bodies Included in the Statutes

Now that the negative aspects of various coverage clauses have been examined, the more important includability provisions will be discussed. Which governmental bodies are covered by the various open meetings laws?

One group of statutes enumerates specific bodies that are required to conduct their business in public, but the statutes name so few bodies that the possibility of restrictive construction is substantial.[95] Typical is the Maine law which requires "any administrative or legislative body of the State, . . . counties, . . . municipalities, or . . . other political subdivision" to hold open meetings.[96] The coverage clause in Delaware includes only "boards and commissions."[97] The weakness of such a clause is that "boards and commissions" could be read to exclude such public bodies as city councils or public authorities from coverage under the law.[98] To ensure includability, some states have enumerated such exhaustive lists of governmental organizations that a public body would be unconvinced by an argument that it was not intended to be included.[99]

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[95]Note, *supra* note 16, at 1205.

[96]ME. REV. STAT. ANN. tit. 1 § 402 (1964).

[97]DEL. CODE ANN. tit. 29, § 5109 (Supp. 1968).

[98]Florida's "sunshine law," FLA. STAT. ANN. § 286.011 (Supp. 1974), which states that boards, commissions, agencies, and authorities are within the act, was held to include the state legislature as well. Miami Beach v. Berns, 245 So. 2d 38, 41 (Fla. 1971). The recently enacted Tennessee law appears to have a narrow coverage clause. The act defines a governing body as "any public body which consists of two or more members, with the authority to make decisions for or recommendations to a public body on policy or administration." Ch. 442, § 2, [1974] Tenn. Acts 63.

[99]Comment, *The Iowa Open Meetings Act: A Right Without a Remedy?*, 58 IOWA L. REV. 210, 211 (1972). The Iowa law was drafted to cover the entire gamut of public bodies:

> (1) Any board, council or commission created or authorized by the laws of this state. (2) Any board, council, or commission, trustees, or governing body of any county, city, town, township, school corporation, political subdivision, or tax-supported district in this state. (3) Any committee or any such board, council, commission, trustees, or governing body.

IOWA CODE ANN. § 28A.1 (Supp. 1974). The act does not specifically mention school boards but the Iowa Supreme Court, in Dobrovolny v. Reinhardt, 173 N.W.2d 837, 840 (Iowa 1970), held that they were included within the act as a public agency. California's State Agency Act, CAL. GOV'T CODE § 11121 (West Supp. 1973), and Ralph M. Brown Act, CAL. GOV'T CODE §§ 54950.5-52.5 (West 1966) *as amended*, (West Supp. 1973), have perhaps the most extensive coverage sections to be found. *See* FREEDOM OF INFORMATION CENTER, REP. NO. 232, NEWS ACCESS IN THE SOUTHWEST 1 (1969).

Some states have ensured includability by adding a "catchall" provision which encompasses all bodies "supported wholly or in part by public funds or expending public funds."[100] Other statutes cover bodies which are "entrusted with powers of recommending the expenditure of . . . public funds."[101] Yet others include bodies that perform a "governmental function."[102] While the latter "catchall" provision appears to be comprehensive, it is arguable that "governmental functions" do not include proprietary functions. Thus, a nongoverning body such as a public utility might be found to fall outside the law.[103] It is believed that the "public funds test" offers the most definitive standard for determining whether a particular body falls within an open meetings law. If an agency, committee, commission, council, board, or any other body is not supported by, responsible for, or charged with the appropriation or collection of any public moneys, it seems that the "public" label would not apply, nor would there be a compelling need for opening meetings to the public.[104] This statement, however, is valid only if a state's open meetings law is applicable by state or judicial decree to subcommittees, advisory boards, or groups making public studies.[105] Some of these bodies might not normally expend public funds but instead might merely

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[100]ARK. STAT. ANN. § 12-2803 (1968). The breadth of the act has been further strengthened by the Arkansas Supreme Court which stated that the act should be "liberally interpreted to the end that its praiseworthy purpose may be achieved." Laman v. McCord, 245 Ark. 401, 432 S.W.2d 753 (1968). Other statutes with provisions relating to the expenditure of public funds include KAN. STAT. ANN. § 75-4318 (Supp. 1972); MONT. REV. CODES ANN. § 82-3402 (1966); S.C. CODE ANN. § 1-20.1 (Supp. 1973).

[101]NEB. REV. STAT. § 84-1401 (Supp. 1971).

[102]*E.g.*, MICH. COMP. LAWS ANN. § 15.251 (Supp. 1974); N.J. STAT. ANN. § 10:4-2 (Supp. 1974).

[103]FREEDOM OF INFORMATION CENTER, *supra* note 76, at 2. *But see* Raton Pub. Serv. Co. v. Hobbes, 76 N.M. 535, 417 P.2d 32 (1966), where the court held that the board of directors of a corporation operating a public utility was a "governmental board" within the meaning of the former New Mexico open meetings law, ch. 120, § 1, [1959] N.M. Laws, *as amended*, N.M. STAT. ANN. §§ 5-6-23 to -26 (Supp. 1974) (a totally new and more comprehensive act).

[104]South Dakota appears to extend the public funds test even further by providing that agencies which are "non-tax paying and derive a source of revenue directly from public funds" shall open their meetings to the public. S.D. COMP. LAWS ANN. § 1-25-1 (1968). Query: Could "a source of revenue" be read to include any body under the act that receives a grant or other subsidy from the state? California's Ralph M. Brown Act appears to be the only statute which specifically applies to private groups. "[The] term 'local agency' shall include all private nonprofit organizations that receive public money to be expended for public purposes pursuant to the 'Economic Opportunity Act of 1964' (P.L. 88-452; 78 Stat. 508)." CAL. GOV'T CODE § 54951.1 (West Supp. 1973).

[105]Several statutes appear to include such groups. *E. g.*, CAL. GOV'T CODE § 54952.3 (West Supp. 1973) (advisory commissions, committees, and bodies); KAN. STAT. ANN. § 75-4318 (Supp. 1972) (subcommittees and other subordinate groups); NEB. REV. STAT. § 84-1401 (Supp. 1971) (subunits). At least one state specifically excludes "study, research and investigation commissions and committees . . . ." N.C. GEN. STAT. § 143-318.4 (1974).

present findings or make recommendations. It would defeat the purpose of the open meetings principle if a body specifically named by statute could create an ad hoc or subordinate body which would not be directly responsible for public funds but which could resolve important issues and make decisions, leaving the parent group to merely rubber-stamp subcommittee actions.[106] Regardless of the particular language used in the coverage provision, if it acts unnecessarily to deny public access to governmental meetings, the purpose of the open meetings principle is frustrated.

C. *Meetings Defined*

Assuming that a particular governmental body is not exempt from an open meetings law due to one of the reasons discussed above, it must be determined whether a particular gathering of any of that body's members falls within the act and if so, whether and by what procedure a meeting may be closed to the public. Statutory exceptions sometimes permit closed executive sessions under certain circumstances. Executive sessions will be discussed in the following section. First, "meeting" must be defined.

The most effective statutes appear on their faces to be those containing dictionary-style definitions of what is considered to be a public meeting or proceeding. In this commentator's opinion, an adequate definition of a public meeting must contain, *inter alia:* (1) a statement of how many members of a particular body gathering together constitute a public meeting;[107] (2) a provision which excludes social meetings or chance encounters from the requirement of openness;[108] and (3) a specific delcaration that all the deliberative stages of the decision-making process are required to be open to the public.[109]

There is an endless number of gatherings and assemblages at which members of a governmental body could meet for various purposes;[110] officials could congregate for a business proceeding on Friday and for a fishing excursion on Saturday. The former clearly should fall within an open meetings act, but the latter, if purely a social gathering, should not.[111] Public officials cannot be expected to become so bound by anti-

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[106]*See* Note, 49 TEXAS L. REV. 764, 767 (1970). *But cf.* Note, *supra* note 16, at 1206, where the point is raised that privacy in a preliminary meeting could facilitate the fact-finding process.

[107]*E.g.,* COLO. REV. STAT. ANN. § 3-33-2(a) (Supp. 1973) (two or more members).

[108]TEX. REV. CIV. STAT. ANN. art. 6252-17, § 1(a) (Supp. 1974) (social functions); ch. 442, § 2, [1974] Tenn. Pub. Acts 63 (chance meetings).

[109]*E.g.,* ORE. REV. STAT. § 192.610(5) (Supp. 1973).

[110]Comment, *Access to Governmental Information in California,* 54 CALIF. L. REV. 1650, 1651 (1966).

[111]*See generally* Wickham, *supra* note 45, at 483.

secrecy laws that they become prisoners of the open meetings principle. Consequently, the definition of a "meeting" or "public proceeding" as used in open meetings legislation must be drafted so that the public's desire for access does not act unreasonably to hinder the activities of an official's personal and public activities.[112]

The problem of determining which particular gatherings constitute meetings within an open meetings act has been addressed in a variety of ways. Many states have used an approach that does not define meetings but focuses instead on the activity that takes place at undefined meetings. States subscribing to the latter approach often use the words "action" and "official" in their statutes. For example, the Montana law opens meetings of affected bodies "at which any action is taken,"[113] and the New Jersey act admits the public only at meetings where "official action is taken."[114] The Wyoming act contains substantially the same language as the Montana act but is substantially less vague; it defines the term "action."

> *"Action"* means the transaction of official business of an agency including a collective decision of a governing body, a collective commitment or promise by a governing body to make a positive or negative decision, or an actual vote by a governing body upon a motion, proposal, resolution, rule, order or ordinance . . . .[115]

New Jersey clearly defines "official action" as a "determination made by vote."[116] Such a narrow definition obviously precludes a court from liberally construing the section to cover preliminary stages of the decisionmaking process. This substantial loophole could allow members of a public body to agree in secret on how they will vote on a particular issue and adjourn, with formal voting to take place at a public meeting.

Florida's "sunshine law," which defines as public those meetings where "official acts are to be taken,"[117] has been construed to have wide coverage.[118]

> Every thought, as well as every affirmative act, of a public official as it relates to and is within the scope of his official duties, is a matter of public concern; and it is the entire decisionmaking process that the legislature intended to affect by the enactment of the statute . . . .

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[112]*See* Comment, *supra* note 110, at 1651.

[113]MONT. REV. CODES ANN. § 82-3402 (1966).

[114]N.J. STAT. ANN. § 10:4-3 (Supp. 1974).

[115]WYO. STAT. ANN. § 9-692.11(a)(i) (Supp. 1973). Washington has a very similar definition of "action." WASH. REV. CODE ANN. § 42.30.020(3) (1972).

[116]N.J. STAT. ANN. § 10:4-2 (Supp. 1974).

[117]FLA. STAT. ANN. § 286.011(1) (Supp. 1974).

[118]*But see* Note, *Government in the Sunshine: Promise or Placebo?*, 23 U. FLA. L. REV. 361, 364 (1971), where the author suggests that all of the deliberative stages are not adequately covered in Florida.

> Every step in the decisionmaking process, including the decision itself, is a necessary preliminary to formal action. It follows that each step constitutes an "official act," . . . within the meaning of the act.[119]

Whether the other "action taken" statutes will be so liberally construed remains to be seen.[120]

One group of state laws does not directly define meetings but describes them in terms of dealing with the formality of the proceeding. Typical of this approach is Arkansas' "Freedom of Information Act"[121] where all "formal or informal, special or regular" meetings are declared to be open and public meetings.[122] South Carolina used the same language,[123] and Iowa's law states that " 'meetings' include all meetings of every kind . . . whether formal or informal."[124] Standing alone, such language is vague since the threshold question of what constitutes a meeting is not answered. Arkansas and South Carolina provide guidance through sections in their respective acts which reflect the strong intent of their lawmakers to make the statutes comprehensive.[125] Iowa has no such statement of policy; consequently, its law is vulnerable.[126] Unfortunately, at least two acts provide no guidance whatsoever to those attempting to determine if a meeting is one which is required to be open. Louisiana and North Dakota merely state without amplification that all meetings of affected bodies shall be open to the public.[127] Such weak language paves the way for informal meetings at a member's home for the transaction of important business, leaving for the agendas at regular meetings items of an administrative or noncontroversial character.

Surprisingly, many statutes make no reference to the number of persons who must be present for the antisecrecy requirement to oper-

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[119]Times Publishing Co. v. Williams, 222 So. 2d 470, 473 (Fla. 1969).

[120]Other statutes are similar to the "action taken approach" and are equally vague as to applicability in the deliberative stage. Delaware opens only those meetings at which "business is transacted." DEL. CODE ANN. tit. 29, § 5109 (Supp. 1968). Colorado takes coverage a step further by using the words "at which any public business is discussed" in addition to the words "at which any formal action is taken." COLO. REV. STAT. ANN. § 3-33-2(a) (Supp. 1973).

[121]ARK. STAT. ANN. §§ 12-2801 to -2807 (1968).

[122]*Id.* § 12-2805 (1968).

[123]S.C. CODE ANN. § 1-20.3(a) (Supp. 1973).

[124]IOWA CODE ANN. § 28A.1 (Supp. 1974).

[125]ARK. STAT. ANN. § 12-2802 (1968); S.C. CODE ANN. § 1-20 (Supp. 1973). Both of these statutes cover the decisionmaking process.

[126]*Cf.* Letter from Kenneth Macdonald, Editor, The Register and Tribune (Des Moines), to William R. Wright, May 20, 1974, copy on file at the *Mississippi Law Journal*, where Mr. Macdonald observes: "Unless [open meeting laws] are drafted very carefully, they create more problems than they solve."

[127]LA. REV. STAT. ANN. § 42-7 (1965), *as amended*, (Supp. 1974); N.D. CENT. CODE § 44-04-19 (1960).

ate.[128] Others specify that there must be a "quorum,"[129] "majority,"[130] or at least "two or more"[131] members of the public body present. The quorum requirement provides an opportunity for evasion of the act: a group of officials comprising a majority but less than a quorum could convene at a closed meeting, discuss the issues, reach a resolution, and agree to vote accordingly at a subsequent open meeting. Where a body consists of bipartisan members, this loophole could become quite convenient to the members of the political party with the greatest representative membership on the board or commission. A statute that covers meetings where a majority is present is an improvement since constituent parts of a body holding the numerical power to control a vote are required to meet in the open. Nothing, however, would prevent a minority group with political and persuasive power from meeting for the purpose of discussing public business. The most effective and inflexible language declares that a meeting of "two or more members" may be considered public.[132]

As previously suggested, open meetings legislation should not interfere with the social lives of the members of public bodies. It is natural that people who have daily contact at work will have social relationships during nonworking hours. Furthermore, business colleagues, when interacting socially, tend to discuss subjects in which they have a community of interest, most notably, their work.[133] An open meetings law which is so strong that its scope would be construed to cover discussions of public policy incidental to social encounters is unreasonably restrictive. Apparently in recognition of this contingency, some statutes specifically exclude social meetings from coverage.[134] In addition, some legislatures have provided for the exclusion of fortuitous meetings of members of a public body.[135]

Notwithstanding the belief that social meetings should be specifically excluded, it should be emphasized that a meeting held ostensibly for social purposes must not be used as a subterfuge to escape open meetings legislation.[136] Such illegal meetings are of course hard to establish, and an attempt to itemize hypothetical gatherings that are or are

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[128] *E.g.*, DEL. CODE ANN. tit. 29, § 5109 (Supp. 1968); MO. ANN. STAT. § 610.010(3) (Supp. 1974); OKLA. STAT. ANN. tit. 25, § 201 (Supp. 1973).

[129] *E.g.*, N.M. STAT. ANN. § 5-6-23(B) (Supp. 1974).

[130] *E.g.*, N.C. GEN. STAT. § 143-318.2 (1974).

[131] *E.g.*, COLO. REV. STAT. ANN. § 3-33-2(a) (Supp. 1973).

[132] *Id.*

[133] *See* 35 ORE. OP. ATT'Y GEN. 543, at 2-3 (1973).

[134] *E.g.*, NEB. REV. STAT. § 84-1402(2) (Supp. 1971).

[135] "Nothing in this chapter shall be construed as to define a meeting as a chance meeting of two or more members of a public body . . . ." VA. CODE ANN. § 2.1-341(a) (Supp. 1973).

[136] *See* 35 ORE. OP. ATT'Y GEN. 543, at 2-3 (1973).

not considered to be social meetings would serve no value.[137] At best, it is believed that legislatures should specifically exclude social or chance meetings, and leave to the courts and public officials the duty of interpretation in light of the particular circumstances of each gathering. It is not the actual occurrence of a meeting that precludes confidentiality but the purpose for which it is held that is important.[138]

Except for the "quorum" provision,[139] this writer believes that one of the better definitions of what constitutes a "meeting" within an open meetings act is found in the Texas law.

> "Meeting" means any deliberation between a quorum of members of a governmental body at which any public business . . . is discussed or considered, or at which any formal action is taken. It shall not be construed that the intent of this definition is to prohibit the gathering of members of the governmental body in numbers of a quorum or more for social functions unrelated to the public business which is conducted by the body or for attendance of regional, state, or national conventions or workshops as long as there is no formal action taken and there is no deliberation of public business which will appear on the agenda of the respective body.[140]

The act further clarifies which meetings are covered, by defining "deliberation" as "[a] verbal exchange between a quorum of members of a governmental body attempting to arrive at a decision on any public business."[141] Thus, in Texas it is relatively clear that: (1) a quorum of members gathered together may constitute a meeting; (2) purely social meetings are not covered; and (3) the legislature intended that the entire decisionmaking process be carried out in the open.

D. Executive and Closed Sessions

In most states, "[f]reedom of information is now, by statute, the rule, and secrecy the exception."[142] The exceptions are the offspring of the general premise that while the people must be apprised of how their government is functioning, it is sometimes necessary for government to operate free from public scrutiny in order to be effective.[143] There are

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[137]*Id.*

[138]*See id.*

[139]See text accompanying notes 128 through 132 *supra* where criticism is directed toward those statutes which state that a meeting is public only when a quorum is present. This writer suggests that the better provisions state that a meeting may consist of *two or more members* of a public body.

[140]Tex. Rev. Civ. Stat. Ann. art. 6252-17, § 1(a) (Supp. 1974).

[141]*Id.*

[142]Papadoupoulos v. State Bd. of Higher Educ., 8 Ore. App. 445, 494 P.2d 260 (Ct. App. 1972).

[143]*See* Comment, *supra* note 110, at 1657.

two basic statutory methods by which a meeting may be closed to the public. First, a body may be specifically named as one falling outside the act. This method has already been discussed.[144] Second, open meetings statutes may expressly grant public bodies the option of holding "executive" or closed sessions[145] even though the bodies themselves are not excluded from coverage. Under the former method, the excluded body may always meet in secret,[146] but under the latter method, public bodies must open their meeting room doors except under certain conditions.

Exceptions for executive sessions generally fall into one of two basic categories: (1) those which allow calling of executive sessions merely by vote, but allow no final or binding action to be taken therein;[147] (2) those which allow closed sessions when one or more of a group of specific subjects are to be discussed.[148]

1. Executive Sessions Where No Final Action is Taken

Typical of the first group are the Arizona statutes, which provide that "executive sessions may be called only by a majority vote of the members" of affected bodies, but "no ordinance, order, rule, resolution, regulation, contract, appointment or other official action may be finally approved at such executive sessions."[149] The Delaware law also uses the "final action" approach, but the language is vague: "Nothing contained herein shall be construed to prohibit executive sessions or conferences . . . at which no business shall be transacted."[150] Most states utilizing the "final action" approach require that a meeting must be convened in the open with the vote of each member on the question of whether the public body is to retire into executive session being cast publicly.[151]

The "final action" approach is obviously very flexible; conse-

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[144]Text accompanying notes 87 through 94 *supra*.

[145]An "executive session" means a meeting from which the public is excluded. VA. CODE ANN. § 211-341(c) (1973).

[146]When a particular governmental body is expressly exempted from open meetings legislation, there is, of course, no question as to that body's right to meet secretly. Therefore, criticism is not aimed at members of the body themselves for trying to circumvent the law. If one feels that a public body has been unnecessarily exempted, fault lies with the legislature.

[147]*See* statutes cited at notes 149 through 151 *infra*.

[148]*See* statutes cited at notes 153, 154, 160, 164, 166 through 169, 171, 173 through 176 *infra*. The two categories have been labeled the "final action approach" and the "subject-matter approach" by one writer. Note, *supra* note 16, at 1208-09.

[149]ARIZ. REV. STAT. ANN. § 38-431.02(A)(2)-(3) (Supp. 1973). Substantially the same language is found in other states. *E.g.*, ME. REV. STAT. ANN. tit. 1, § 404 (1964).

[150]DEL. CODE ANN. tit. 29, § 5109 (Supp. 1968).

[151]*E.g.*, NEB. REV. STAT. § 84-1401 (Supp. 1971); OKLA. STAT. ANN. tit. 25, § 201 (Supp. 1973).

quently, it does not effectively inhibit secrecy. Conceivably, the open meeting at which the final vote is taken could be no more than a pro forma ratification of decisions made behind closed doors.[152] The fact that the public may discover which members voted to close the meeting serves only as a mild deterrent to the holding of a closed meeting where a law permits a public body to go into executive session at any time for any reason.

2. Executive Sessions Where Certain Subject Matter Is Discussed

Public bodies in most states operate under a statutory exclusion to the open meetings requirement which permits them to hold executive sessions when a specific subject matter is to be discussed.[153] There are scores of discussion topics named in the various statutes; only the more common provisions will be discussed here.

The subject matter most often recognized as sensitive concerns the hiring, firing, and disciplining of personnel.[154] Allowing such matters to be discussed in confidence has been well-received by courts[155] and commentators.[156] Public business is of concern to the entire electorate, but where the proceedings at a public meeting focus on an individual, his personal privacy should be preserved.[157] Even though a public employee is supported by the taxpayers, he, like a nonpublic employee, should not have to fear that his personal shortcomings might be discussed in a public meeting.[158] Discussions at public meetings are nonjudicial in na-

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[152]*See* GILSON 92.

[153]*E.g.*, MONT. REV. CODES ANN. § 82-3402 (1966); N.C. GEN. STAT. § 143-318.3 (1974); S.C. CODE ANN. § 1-20.3 (Supp. 1973).

[154]ARIZ. REV. STAT. ANN. § 38-431.02(B) (Supp. 1972); OKLA. STAT. ANN. tit. 25, § 201 (Supp. 1973); ORE. REV. STAT. §192.660(1) (Supp. 1973). Arkansas' Freedom of Information Act states that "[e]xecutive sessions will be permitted only for the purpose of discussing or considering employment, appointment, promotion, demotion, disciplining or resignation of any public officer or employee." ARK. STAT. ANN. § 12-28-5 (1968). Illinois extends the exception to "collective negotiating matters between public employers and their employees or representatives to employment." ILL. ANN. STAT. ch. 102, § 42(a) (Smith-Hurd Supp. 1974).

[155]*See, e.g.*, Lucas v. Board of Trustees, 18 Cal. App. 3d 988, 96 Cal. Rptr. 431 (Dist. Ct. App. 1971). *But see* City of Miami v. Burns, 245 So. 2d 38 (Fla. 1971) (personnel matter exclusion not within statute).

[156]*E.g.*, Wickham, *supra* note 45, at 485; Note, *supra* note 16, at 1208-09. The personnel exception, however, has not been free of criticism. Construing the term "personnel matters" very broadly, school board meetings at which general salary levels are discussed have been held in secret on the grounds that salary levels are a personnel matter. Letter from Kenneth Macdonald, Editor, The Register and Tribune (Des Moines), to William R. Wright, May 20, 1974, copy on file in the *Mississippi Law Journal*. One newspaper editor believes that the term " 'personnel' is too broad." Questionnaire answered by Robert S. McCord, Executive Editor, Arkansas Democrat (Little Rock), May 1974.

[157]Wickham, *supra* note 45, at 483.

[158]*See generally* Comment, *supra* note 110, at 1657.

ture; therefore, the weapons of cross-examination and confrontation for combating the possibility of irreparable harm are not available. On the other hand, lawmakers have recognized that a closed meeting could operate to allow the bringing of unfounded and malicious charges by the members of a public body against an employee, appointee, or job applicant.[159] With this in mind, several statutes are drawn to protect the individual involved by enabling him to demand an open meeting when he is the focal point of personnel discussions.[160]

Discussions of personnel matters in closed meetings also benefit public bodies themselves. It is believed that the governmental processes will function much more smoothly if staffing and organizing can be done in private.[161] In addition, it is likely that more qualified individuals will be desirous of participating in government service if their privacy is assured.[162] With respect to those already on the public payroll, the assurance of privacy is necessary in order to maintain high morale among government employees.[163]

Similar to the personnel exception are provisions which permit executive sessions when the subject to be discussed "tend[s] to prejudice the reputation and character" of an individual.[164] Although such a provision is susceptible of broad construction, its inclusion is necessary in order to cover those undefinable situations which are so numerous that any attempt to itemize all of them in a statute would be futile.[165] To prevent members of a public body from using the provision to conceal their own acts of misfeasance and malfeasance, some statutes expressly declare that the reputation exception does not apply to any member of the public body itself.[166]

Another frequently mentioned exclusion concerns those meetings during which proposed "real estate transactions"[167] are discussed, in-

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[159]Note, *supra* note 16, at 1208.

[160]*E.g.*, N.H. REV. STAT. ANN. § 91-A:3(II)(a) (Supp. 1973); ORE. REV. STAT. § 192.660(b) (Supp. 1973).

[161]Wickham, *supra* note 45, at 485.

[162]Comment, *Open Meetings in Virginia: Fortifying the Virginia Freedom of Information Act*, 8 U. RICH. L. REV. 261, 267 (1974).

[163]Note, *supra* note 106, at 771.

[164]ALASKA STAT. § 44.62.310(c)(2) (Cum. Supp. 1973); N.H. REV. STAT. ANN. § 91-A:3(II)(c) (Supp. 1973).

[165]A Massachusetts school committee went into executive session to consider the suspension of a high school student. When the student demanded an open hearing, a federal district court held for the committee since Massachusetts law permitted executive sessions for meetings during which the discussions might adversely affect one's reputation. Pierce v. School Comm., 322 F. Supp. 957 (D. Mass. 1971). Such circumstances would be difficult to specify in a list of meetings that could be closed to prevent damage to one's reputation.

[166]N.H. REV. STAT. ANN. § 91-A:3(II)(c) (Supp. 1973).

[167]VT. STAT. ANN. tit. 1, § 313(a)(2) (Supp. 1973).

cluding the "[a]cquisition, lease, or alienation of property."[168] Montana has an even broader exception which covers meetings involving "[t]he purchasing of public property, the investing of public funds or other matters involving competition or bargaining which, if made public may adversely affect the . . . financial interest of the state or any political subdivision or agency of the state."[169] The reasoning behind these exclusions is sound: public officials should discuss property acquisitions behind closed doors to prevent speculation from driving prices up at the expense of the taxpayers.[170] It is arguable that closed sessions increase the possibility of purchases that would profit members of a public body themselves. To lessen the chance of this occurrence, some laws require that final votes on purchases be taken in open session.[171] It has been suggested that despite a statutory provision for closing meetings where real estate transactions are to be discussed, the keeping of minutes of the deliberations could act as a deterrent to self-serving deals.[172]

A few states permit executive sessions for discussion of matters concerning such topics as "national security,"[173] or "clear and imminent peril to the public safety."[174] While the justification for the first example is obvious, it seems unlikely that a state board, commission or agency would have occasion to discuss such matters. With respect to the public safety, the legislative purpose presumably lies in the desire to extend the prerogative of holding closed sessions to those agencies not specifically exempted by name which are engaged in the prevention and investigation of crime. If so, the language should be more specific to avoid flexibility.[175] South Carolina's open meetings law allows closed meetings for the discussion of "national" and "state" security matters.[176] A law which covers matters of state security could be construed to extend to discussion of financial security matters, surely a prospect within the purpose of the act.

Several desirable exceptions found among existing acts are not dis-

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[168]N.C. GEN. STAT. § 143-318.3(1) (1974). A similar provision is found in New Hampshire. N.H. REV. STAT. ANN. § 91-A:3(II)(d) (Supp. 1973).

[169]MONT. REV. CODES ANN. § 82-3402(4) (1966). Wisconsin's open meetings law contains similar language. WIS. STAT. ANN. § 66.77 (30)(d) (Supp. 1973).

[170]*See* 46 CHI.-KENT L. REV. 207, 211 (1969).

[171]*E.g.*, VA. CODE ANN. § 2.1-344(c) (Supp. 1973).

[172]*See* Goldman v. Zimmer, 64 Ill. App. 2d 277, 212 N.E.2d 132 (1965), *rev'd in part on other grounds sub nom.* Goldman v. Moore, 35 Ill. 2d 450, 220 N.E.2d 466 (1966).

[173]*E.g.*, WYO. STAT. ANN. § 9-692.14(a)(iv) (Cum. Supp. 1973).

[174]*E.g.*, VT. STAT. ANN. tit. 1, § 313(a)(5) (Supp. 1973).

[175]*E.g.*, In Texas, public bodies may discuss in executive session matters "regarding the deployment, or special occasions for implementation, of security personnel devices." TEX. REV. CIV. STAT. ANN. art. 6252-17, § 2(j) (Supp. 1974).

[176]S.C. CODE ANN. § 1-20.3(c)(4) (Supp. 1973).

cussed here.[177] They, as well as those discussed above, call for prudent drafting and the narrow drawing of exceptions, to prevent the spirit of the open meetings principle from being defeated through subterfuge.

E. Notice Requirements

A law requiring all public meetings to be open to the public would be of little value if the public had no notice that the proceedings were to be held.[178] In the early 1960's, only about one quarter of the state open meetings statutes then existing contained notice provisions.[179] Some remain uncured.[180] Some of the more recently enacted statutes expressly require that the public be notified of impending public meetings;[181] even in the absence of statutory notice provisions, however, it is reasonable to assume that public notice is impliedly required in open meetings laws.[182]

Some statutes expressly require notice but provide only that "adequate"[183] or "reasonable"[184] notice is necessary. Such language is vague and lends itself to varying application.[185]

Perhaps in recognition that the public has constructive notice of when and where regular meetings are to be held,[186] some states do not

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[177]*E.g.*, "To consider preliminary negotiations involving matters of trade or commerce in which the governing body is in competition with governing bodies in other states or nations." ORE. REV. STAT. § 192.660(2)(c) (Supp. 1973). "[T]o consider the conferring of honorary degrees or the acceptance of gifts, donations and bequests which the donor or proposed donor has requested in writing to be kept confidential." S.C. CODE ANN. § 1-20.3(c)(5) (Supp. 1973).

[178]*See* 46 CHI.-KENT L. REV. 207, 211 (1969).

[179]Note, *supra* note 16, at 1207.

[180]*See, e.g.*, code sections for the states of Alabama, Delaware, North Dakota, Oklahoma, and Utah, at note 3 *supra*.

[181]*E.g.*, MO. ANN. STAT. § 610.020 (Supp. 1974) (enacted in 1973); ORE. REV. STAT. § 192.640 (Supp. 1973) (enacted in 1973). *But see* GA. CODE ANN. §§ 40-3301 to -3303 (Supp. 1973) (enacted in 1972); S.C. CODE ANN. §§ 1-20 to -20.4 (Supp. 1973) (enacted in 1972).

[182]*Cf.* Hamrick v. Town of Albertville, 223 Ala. 216, 135 So. 326 (1931). The Alabama Supreme Court, in holding that an improvement assessment made at a closed meeting was defective, said that the result would be the same if no notice of the meeting were given to property owners.

[183]Ch. 442, § 2, [1974] Tenn. Pub. Act 63.

[184]*E.g.*, IOWA CODE ANN. § 28A.4 (Supp. 1974).

[185]For example, a chancery court in Memphis recently held that the Tennessee provision requiring "adequate" notice for regular and special meetings was unconstitutional and void for vagueness. City of Memphis v. Memphis Publishing Co., No. 78995-2R.D. (Shelby County, Tenn. Ch. May 6, 1974), *rev'd*, Shelby Eq. No. 5 (Tenn. July 29, 1974). The chancellor said:

> There is no way to construe the term ["adequate"] except to say that it means adequate public notice under the circumstances, and that would mean different things to different people of common intelligence.

Id.

[186]*See* Note, *supra* note 106, at 770.

require similar notice for regular meetings as for special or emergency meetings.[187] One method of giving notice for regular meetings is to require public bodies to post or publish at least once each fiscal year the dates, times, and locations[188] of the meetings.[189] Other states, like California, require that notice be given before every meeting.[190]

When special or emergency meetings are scheduled, some states require 24 hours' notice.[191] Arkansas and Texas, however, require that only 2 hours' notice be given for extraordinary meetings.[192] Such short notice could enable officials to call "instant" meetings in hopes of avoiding public scrutiny. Outweighing this possibility, however, is the need for immediate action in exigent circumstances. So long as representatives of the media have at least 2 hours' notice of special meetings, the possibility of a meeting going unobserved because of short notice is greatly reduced.

Since it would be impractical to require that an effort be made to notify all citizens of an impending meeting, most statutes enumerate those to whom notifications should be directed. Arkansas requires that notice of regular meetings be furnished only to those requesting such information and in the case of special or emergency meetings, to the "representatives of the newpapers, radio stations and television stations . . . in the county in which the meeting is to be held and which have requested to be so notified . . . ."[193] Other statutes require the posting and publishing of notices for the general public in addition to media notification.[194] No matter how a statute's notice requirement is drawn, it will be adequate if it is specific and requires that representatives of the media be notified in time to attend hastily called public meetings.

F. Sanctions and Remedies for Enforcement

Legislative action without enforcement provisions is inadequate to

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[187]*E.g.*, ILL. ANN. STAT. ch. 102 § 42.02 (Smith-Hurd Supp. 1974); MICH. COMP. LAWS ANN. § 15.253 (Supp. 1974); PA. STAT. ANN. tit. 65, § 253(A)(1959).

[188]Implicit in the purpose of open meetings legislation is that the location of all meetings should be at a place accessible to all citizens. Oregon makes this perfectly clear: "A governing body shall not hold a meeting at any place where discrimination on the basis of race, creed, color, sex, age, or national origin is practiced." ORE. REV. STAT. § 192.630(3) (Supp. 1973). Nebraska requires all meetings to be held in public buildings. NEB. REV. STAT. § 84-1402(3) (Supp. 1971).

[189]*E.g.*, ILL. ANN. STAT. ch. 102, § 42.02(a) (Smith-Hurd Supp. 1974); MICH. COMP. LAWS ANN. § 15.251(2) (Supp. 1974); PA. STAT. ANN. tit. 65, § 253(A) (1959).

[190]CAL. GOV'T CODE § 54954 (West 1966).

[191]*E.g.*, ILL. ANN. STAT. ch. 102, § 42.02 (Smith-Hurd Supp. 1974); PA. STAT. ANN. tit. 65, § 253(B)(1959).

[192]ARK. STAT. ANN. § 12-2805 (1968); TEX. REV. CIV. STAT. art. 6257-17 § 3(A)(b) (Supp. 1974).

[193]ARK. STAT. ANN. § 12-2805 (1968).

[194]*E.g.*, ILL. ANN. STAT. ch. 102, § 42.02-.03 (Smith-Hurd Supp. 1974).

prevent public officials from conducting illegally closed meetings.[195] While some statutes surprisingly offer no methods of enforcement,[196] most open meetings laws generally provide sanctions in terms of criminal penalties, injunction and nullification.[197]

Several states provide for fines and short jail sentences for public officials found guilty of the misdemeanor of holding meetings not in accordance with open meeting statutes.[198] The fines range from a minimum of $10[199] to a maximum $2,000,[200] and jail terms can be imposed for periods from 1 day[201] to 1 year.[202] Several states provide for punishment by both fine and imprisonment.[203] The extreme variations of criminal sanctions indicate the varying attitudes among states concerning the seriousness of illegally closed meetings. Despite the existence of the severer penalties, there appears to be a reluctance on the part of prosecutors to bring charges and vigorously seek convictions in cases where violations are alleged.[204] One reason for this may be the recognition that the laws are in many cases vague to the point that the establishment of an intent to violate the law would be difficult.[205] It is also suggested that prosecuting attorneys, being politicians, are reluctant to charge a popular fellow-politician for committing what some may believe to be a harmless crime.[206] Although a misdemeanor conviction and resulting punishment would probably have a deterring effect on public officials, two additional considerations seem to outweigh any such effect. First, the objective of open meetings legislation is not to make criminals out of public officials, but to subject them to the scrutiny of the citizenry.[207] Second, the harm inflicted on society by a single violation of an open meetings law, especially where there is also a provision for invalidating

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[195]Wickham, *supra* note 45, at 495.

[196]*E.g.*, Alaska, North Dakota, South Dakota, and Vermont code sections cited at note 3 *supra*.

[197]Comment, *supra* note 162, at 268-69.

[198]*E.g.*, ALA. CODE tit. 14, § 394 (1958); IND. ANN. STAT. § 5-14-1-6 (1974); IOWA CODE ANN. § 28A.7-.8 (Supp. 1974).

[199]ALA. CODE tit. 14, § 394 (1958) (fine ranges from $10 to $500); PA. STAT. ANN. tit. 65, § 254 (1959) (fine ranges from $10 to $25).

[200]LA. REV. STAT. ANN. § 42:9B (Supp. 1974) (first offenders subject to fines ranging from $100 to $1,000 while second offenders subject to fines ranging from $250 to $2,000 in addition to possible imprisonment for first or successive offenses).

[201]The Indiana statute provides for a fine and/or sentence in the county jail for a period "not to exceed 30 days." IND. ANN. STAT. § 5-14-1-6 (1974).

[202]ME. REV. STAT. ANN. tit. 1, § 406 (1964) (imprisonment up to 1 year).

[203]*E.g.*, ARK. STAT. ANN. § 12-2807 (1968); IND. ANN. STAT. § 5-14-1-6 (1974); LA. REV. STAT. ANN. § 42:9B (Supp. 1974).

[204]This conclusion was reached after no reported cases were found in which the criminal sanction was applied.

[205]*See* Note, *supra* note 106, at 773.

[206]Comment, *supra* note 162, at 269.

[207]Comment, *supra* note 110, at 1662.

any action taken,[208] is not necessarily serious enough for the imposition of criminal penalties. If a criminal penalty *must* be used, a more sensible application might be to a situation where a public official repeatedly and willfully violates an open meetings law,[209] so that obscure, inadvertant violations would not be criminalized. Intent would not be difficult to establish since repeated violations could hardly pass as inadvertant. It is believed, however, that there are other, more realistic methods of retribution that leave fewer scars on the public official but remain effective.[210] These are discussed below.

1. Injunction and Mandamus

The similar remedies of injunction and mandamus are available to complainants in many states either as sole[211] or additional[212] remedies for violations of open meetings statutes. The application of either is effective where public officials announce in advance that a meeting will be closed or where citizens discover an impending closed meeting and voice protest.[213] Where members of a public body are successful in meeting in an illegally closed session without prior knowledge of the public, an action for manduamus or injunction would be futile since the illegal discussions would have already taken place.[214] Perhaps an injunction or writ of mandamus would be partially effective where, after the initial violation, a court orders the public body to refrain from future violations. Officials subsequently holding closed meetings would then be subject to the often strict penalties imposed for contempt of court. It is conceivable that the injunction or mandamus could be used to force public officials to rerun publicly the secret deliberations. No case has been found where a statutory provision for injunction or mandamus was so used. Such use would not appear curative, since there would be every reason to believe that the results of a subsequent meeting would be the

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[208]See discussion of the invalidation provision at notes 222 through 233 and accompanying text *infra*.

[209]Note, *supra* note 16, at 1211.

[210]See discussion of the removal and civil sanctions at notes 234 through 237 and accompanying text *infra*.

[211]*E.g.*, ILL. ANN. STAT. ch. 102, § 43 (Smith-Hurd Supp. 1974)(writ of mandamus or other appropriate remedy to secure compliance); MO. ANN. STAT. § 610.030 (Supp. 1974) (injunction); N.H. REV. STAT. ANN. §§ 91 A:7-8 (Supp. 1973) (injunction with stipulation that public bodies forced by court order to open meetings shall be liable for attorneys' fees and court costs).

[212]*E.g.*, ARIZ. REV. STAT. ANN. §§ 38-431.037.04 to .06 (Supp. 1973) (mandamus, invalidation, misdemeanor); IND. ANN. STAT. § 5-14-1-6 (1974) (misdemeanor, injunction, invalidation); IOWA CODE ANN. §§ 28A.1:7-8 (Supp. 1974) (mandamus or injunction, misdemeanor).

[213]*See* Times Publishing Co. v. Williams, 222 So. 2d 470 (Fla. Dist. Ct. App. 1969).

[214]*See* Dobrovolny v. Reinhardt, 173 N.W.2d 837 (Iowa 1970).

same. Such an action might, however, have some prospective deterrent effect. Injunction and mandamus have also been sought to prevent a public body from carrying out decisions reached in an illegally closed meeting. The 1970 Iowa case of *Dobrovolny v. Reinhardt*[215] demonstrates the difficulties of obtaining injunctions and writs of mandamus in general. In that case a group of citizens sought to enjoin a local school board from implementing an attachment plan for splitting a school district into two separate districts. The plaintiffs complained that notice of the meeting at which the plan was formulated was not given to the public as required by Iowa's open meetings law. The court, conceding that a violation had occurred,[216] nevertheless refused to enjoin the school board from carrying out its plan, stating: "Rights already lost and wrongs already committed are not subject to injunctive relief . . . ."[217] The court also refused to issue a writ of mandamus on the ground that the plaintiffs had not made demand for compliance before the meeting was held.[218] In analyzing the ramifications of the case, one writer observed that an order enjoining a public body from violating an open meetings law would be effective only as to violations of the type already committed.[219] For example, in *Dobrovolny* an injunction would have been effective only as to the notice section and not to other violations, such as refusing admittance to the public.[220] With respect to the issuance of an order of mandamus, the public must have the unusual ability to foresee an impending violation.[221]

In retrospect, the value of the injunction and writ of mandamus as sole remedies in a statute seems questionable unless—unlike the Iowa statute—an open meetings law permits a court to bar implementation of any decisions reached during a closed session. The most appropriate means to this end, however, would be to include an additional provision invalidating all action taken in a meeting held not in accordance with an open meetings law, an alternative discussed below.

2. Invalidation

One enforcement measure prominent in several open meetings statutes is invalidation of action taken during a meeting held in violation of the statute. In most instances this remedy is additional to others,[222]

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[215] 173 N.W.2d 837 (Iowa 1970).

[216] *Id.* at 840.

[217] *Id.* at 841.

[218] *Id.*

[219] Comment, *supra* note 99, at 215.

[220] *See id.*

[221] *Id.*

[222] *E.g.*, ARIZ. REV. STAT. ANN. § 38.431.04 (Supp. 1973)(in addition to mandamus and criminal sanction); IND. ANN. STAT. § 5-14-1-6(d) (1974)(in addition to injunction and criminal sanction).

but in a few states invalidation is the only sanction.[223] Where there is not specific reference to the validity of action taken by a public body while in violation of the statute, a few courts have found invalidation implicit.[224] In a 1971 case, a Texas court held that action taken by a school board in violation of the state open meetings law was invalid.[225] The court, noting that under Texas common law action could only be taken by school boards at legally convened meetings, concluded that a meeting in contravention of the Texas open meetings law was not a legally held meeting.[226] New Jersey takes the position that action taken at meetings in violation of the statute is "voidable" in a court proceeding.[227]

It appears that nullification per se might not be desirable, for it is a drastic remedy and worthwhile or critical action may be the victim.[228] Just as undesirable, the public might rely to its detriment on decisions reached at illegally held meetings only to discover that the decisions were found to be null and void.[229] Another difficulty is the closed meeting during which no final action is taken. One court noted that the reach of the invalidation provision would not include the deliberative stage since there is nothing to declare invalid.[230] It is possible that once a suit to declare invalidation has commenced, a public body could, before adjudication, call an open meeting to moot the court action and thus bring itself into compliance with the law.[231] This tactic was thwarted, however, in two cases which held that the subsequent meetings were also invalid.[232] A drawback to invalidation as a sole remedy is that the wrongdoing officials are not deterred from repeated violations. The rem-

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[223]*E.g.*, Wyoming's law provides no enforcement provision per se; however, "[a]ction taken at a meeting not in conformity with this act is null and void." WYO. STAT. ANN. § 9-692.12(a) (Cum. Supp. 1973).

[224]City of Lexington v. Davis, 310 Ky. 751, 221 S.W.2d 659 (Ct. App. 1949); Green v. Beste, 76 N.W. 165 (N.D. 1956). *Contra*, Claremont Taxpayer's Ass'n v. City of Claremont, 184 Cal. App. 2d 763, 7 Cal. Rptr. 805 (Dist. Ct. App. 1960).

[225]Toyah Independent School Dist. v. Pecos-Barstow Independent School Dist., 466 S.W. 2d 377 (Tex. Ct. Civ. App. 1971).

[226]*Id.* at 380.

[227]N.J. STAT. ANN. §§ 10:4-5 (Supp. 1974).

[228]There has been a reluctance on the part of some courts to invalidate action that is worthwhile. *E.g.*, State *ex rel.* Humphrey v. Adkins, 18 Ohio App. 2d 101, 247 N.E. 2d 330 (1969)(expulsion of student); Thomas v. Board of Trustees, 5 Ohio App. 2d 265, 215 N.E.2d 434 (1966)(discharge of police constable); *In re* Seattle Housing Authority, 62 Wash. 2d 492, 383 P.2d 295 (1963)(property selected for low-income housing).

[229]*See* Note, *supra* note 16, at 1214.

[230]Elmer v. Zoning Bd., 345 Mass. 24, 176 N.E.2d 16 (1961).

[231]*See* Note, *supra* note 106, at 775.

[232]Scott v. Town of Bloomfield, 94 N.J. Super. 592, 220 A.2d 667 (L. Div.), *aff'd*, 98 N.J. Super. 321, 237 A.2d 297 (App. Div. 1967), *appeal dismissed*, 52 N.J. 473, 246 A.2d 129 (1968)(per curiam); Kramer v. Board of Adjustment, 80 N.J. Super. 454, 194 A.2d 26 (L. Div. 1963).

edy only affects their actions and not their standing in the eyes of the electorate.

Despite its drawbacks, invalidation is one of the more satisfactory remedies and is the most effective way of preventing permanent injury to the public interest. With the threat of nullification, public officials are less likely to attempt final action on a public issue during an illegally closed proceeding. When invalidation is joined with the injunction and some form of punishment to the wrongdoer, an open meetings statute can be effectively enforced.[233]

3. Other Remedies

This writer generally disapproves of criminal sanction as a means of punishing public officials found in violation of open meetings laws. Other remedies directly penalize the public official without criminalizing him. For example, Minnesota and Washington[234] in recent legislation have stipulated that a violator will be subject to a *civil* penalty of $100. The pertinent section of the Washington statute provides:

> Each member of the governing body who attends a meeting of such governing body where action is taken in violation of any provision of this chapter applicable to him with knowledge of the fact that the meeting is in violation thereof, shall be subject to personal liability in the form of a civil penalty in the amount of one hundred dollars. The civil penalty shall be assessed by a judge of the superior court and an action to enforce this penalty may be brought by any person. A violation . . . does not constitute a crime and assessment of the civil penalty by a judge shall not give rise to any disability or legal disadvantage based on conviction of a criminal offense.[235]

The typical public official would not be willing to pay $100 for the privilege of violating the law; even if his financial conditions were such that the penalty could be painlessly absorbed, the public reaction to repeated violations would certainly be unfavorable.

In addition to the civil penalty, Minnesota recently adopted removal from office for repeated violators. The statute provides:

> Upon a third violation by the same person connected with the same governing body, such person shall forfeit any further right to serve on such governing body or in any other capacity with such public body for a period of time equal to the term of office such person was then serving. The court determining the merits of any action in connection with any alleged third violation shall receive competent, relevant evidence

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[233] *See* Note, *supra* note 106, at 776.

[234] WASH. REV. CODE ANN. § 42.30.120 (1972); ch. 680, § 2, [1973] Minn. Sess. Laws 1548.

[235] WASH. REV. CODE ANN. § 42.30.120 (1972).

> in connection therewith and, upon finding as to the occurrence of a separate third violation, unrelated to the previous violations issue its order declaring the position vacant and notify the appointing authority or clerk of the governing body. As soon as practicable thereafter the appointing authority or the governing body shall fill the position as in the case of any other vacancy.[236]

The coupling of civil sanctions and removal provides Minnesota with a viable method of compelling public officials to comply with that state's open meetings law: a wrongdoing public official has two chances to escape with a civil fine; after the third violation he finds his job to be in jeopardy. Inadvertance should not be an issue at that point. An added advantage of the removal action is that it is effective to replace those officials not subject to ouster by the electorate. Furthermore, while removal is a severe penalty for holding illegal meetings, it does not go so far as to label violators as criminals. Also, by presenting evidence in his defense, the public official would be afforded due process of law and would not be subjected to a politically motivated attempt to remove him.[237]

V. Conclusion

It would be presumptious, indeed, to assert that open meetings legislation is the panacea for the credibility and communications gaps that exist between public officials and the citizens they serve. This writer suggests that the opening of meeting room doors is not the sole answer to misfeasance, malfeasance, and corruption in state government. By the same token, the fact that Mississippi presently does not have open meetings legislation does not imply that the state suffers from the aforementioned problems to a greater degree than do the 46 states which have enacted open meetings laws. If these observations are valid, Mississippi legislators should find no disadvantage in allowing the public to view, first hand, the operation of state and local government. It appears that the lawmakers would welcome public scrutiny and would overwhelmingly pass an open meetings law. Being one of the last states to do so, Mississippi lawmakers would have the advantage of being free to examine—as does this comment—legislation from 46 other states, to scrutinize the judicial interpretations thereof, and to enact an open meetings bill that would be second to none in effectively enabling

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[236]Ch. 680, § 2, [1973] Minn. Sess. Laws 1548.

[237]Wickham, *supra* note 45, at 498. The author of this article, writing at a time when removal was not mentioned in any of the statutes, remarked that "it [is] the only major sanction which has any chance at all of success."

the citizens to exercise their "right to know." If, in studying the other laws, Mississippi legislators reach some of the same conclusions as has this writer, they would realize that to be viable an open meetings law must: (1) evidence a clear intent that open government is to be the policy of the state; (2) ensure that the law is specific as to which bodies are included and which, by necessity, are exempt; (3) define a meeting in such a way that there would be no doubt in the minds of public officials as to which gatherings are covered; (4) draft a provision for executive sessions that does not create a loophole for those meetings not intended to be closed by the statute; (5) provide for adequate notice for all meetings; and (6) ensure that the enforcement provisions are effective and realistic. If these six standards are adhered to, Mississippians would have the greatest possible access to that information to which they are entitled, and public officials would have the means by which to maintain confidentiality when the circumstances are such that closed meetings would be best for the public interest.

William R. Wright II

APPENDIX[238]

A PROPOSED ACT TO REQUIRE OPEN MEETINGS OF PUBLIC BODIES IN MISSISSIPPI

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MISSISSIPPI:

SECTION 1. The Legislature of the State of Mississippi finds that the fundamental philosophy of our democratic society, which holds to the principle that government is the servant of the people, and not the master of them, commands that public business be performed in an open and public manner so that the citizens shall be advised of the performance of public officials and of the decisions that are reached in public activity and in the formation of public policy.

Therefore, it is hereby declared the policy of this state that the formation and determination of public policy is public business and shall not be conducted in secret or behind closed doors. Toward this end, this act shall be construed liberally.

SECTION 2. For purposes of this act, the following words shall have the meaning ascribed herein, unless the context otherwise requires:

(a) "Public body" shall mean: (1) any executive or administrative board, commission, authority, council, department, agency, bureau, or any other policymaking entity, or committee thereof, of the State of Mississippi, supported in whole or in part by public funds or entrusted with powers of recommending the expenditure of, or actually expending public funds, or any political subdivision or municipal corporation of the state, whether such entity be created by statute or executive order, and (2) any standing, interim, or special committee of the Mississippi Legislature, or subcommittee thereof.

(b) "Meeting" shall mean the assemblage of any two members of a public body, whether corporal or by means of electronic equipment, at which public business is discussed, or at which official acts are taken, upon a matter over which the public body has supervision, control, jurisdiction, or advisory power. "Meeting" does not include gatherings of members of a public body for social functions unrelated to the public business which is conducted by the body or for attendance of regional, state, or national conventions or workshops as long as no official action is taken and there is no deliberation of public business which will appear on the agenda of the respective body. "Meeting" does not include chance encounters of members of a public body or any on-site inspection of any project or program.

SECTION 3. All meetings, or any portion thereof, including the de-

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[238]The proposed bill is substantially the same bill that was drafted and prefiled by Senators Ben Stone and Sanford Steckler for the 1975 Mississippi Legislature. The major differences are found in the notice and enforcement provisions.

liberative stage of the decisionmaking process, of any two members of any public body are declared to be public meetings and, therefore, shall be open to the public at all times, except as provided in Section 4 of this act.

SECTION 4. (a) Any public body may enter into executive session for the transaction of public business, the purpose of which would be irreparably prejudiced by an open meeting; provided, however, all meetings of any such public body shall commence as an open meeting, and an affirmative vote of two-thirds (2/3) of all members of any such public body shall be required to permit executive session. The vote of each member on the question of entering into an executive session, the general reason necessitating such executive session, and any action taken shall be recorded and promptly spread upon the minutes of any such public body.

(b) A public body may enter into executive session for the transaction of public business, the purpose of which would be irreparably prejudiced by an open meeting, including, but not limited to, one or more of the following matters which are hereby designated as proper matters for executive session:

(1) Discussion of the character as opposed to the professional competence, or physical or mental health, of a single individual; provided that such individual may require that such discussion be held at an open meeting, and provided that nothing in this subsection shall permit a meeting closed to the public for discussion of the appointment of a person to a public body.

(2) Strategy sessions with respect to collective bargaining or litigation.

(3) Discussion regarding the deployment of security personnel or devices.

(4) Investigative proceedings regarding allegations of criminal misconduct or proceedings during which criminal investigatory material is discussed.

(5) Judicial proceedings, other than at such times as a court or other judicial body deliberates as to or exercises its rulemaking authority, or deliberates as to or decides upon the issuance of administrative orders.

(6) Deliberation of grand juries, and the probation and parole board.

(7) Consultations between any such board, committee, commission, or policymaking body and its attorney in those instances in which advice is sought with regard to pending or contemplated litigation and settlement offers.

(8) Selection of a site or the purchase, exchange, or lease of real property when the discussion thereof would have a detrimental effect on

the negotiating position of such public body or when the discussion thereof would likely cause an increase in price.

(9) Negotiated contracts for prospective gifts or donations to the state or any such board, committee, commission, policymaking body, or any public body under the jurisdiction of any such board, committee, commission, or policymaking body, wherein the discussion thereof would have a detrimental effect on the negotiating position of such board, committee, commission, or policymaking body.

(10) Staff considerations of a public hospital.

(11) Consideration of records exempt from public inspection by law.

(12) Consideration of negotiations involving matters of trade or commerce in which any such board, committee, commission, or policymaking body is in competition with other governing bodies in other states or nations.

(13) Consideration by the Workmen's Compensation Commission of findings of, and hearings before, attorney referees.

(14) Preparation, administration, or grading of test questions and examination data in licensing examinations and similar occasions.

(15) Specific disclosures prohibited by federal law or regulations or by state law.

(16) Medical boards or medical committees when considering individual medical and psychiatric records of an applicant for a disability benefit from a public retirement system, unless said applicant requests that such consideration transpire in an open meeting.

(3) Any such vote whereby executive session is permitted shall be applicable only to that particular assemblage, and only for that portion of that particular assemblage, relative to the stated reason necessitating such executive session. Nothing in this section shall be construed to require that any meeting of any such board, committee, commission, or policymaking body be closed to the public.

SECTION 5. The vote of each member with regard to formal action on any matter of any such public body shall be taken at every meeting and duly recorded in the minutes of such public body.

SECTION 6. Chance meetings, informal assemblages, or electronic communications shall not be willfully used in any manner to promote the formation or deliberation of public business circumventing the spirit or requirements of this act.

SECTION 7. The minutes of a meeting of such public body, whether open or in executive session, shall be promptly recorded showing:

(a) the time and place of the meeting;

(b) the members present;

(c) all motions, proposals, resolutions, orders, ordinances, regulations, statutes and measures discussed;

(d) the results of all votes, by name, of each member voting or declining to vote; and

(e) the action taken at such meeting.

All votes cast in such meetings shall be recorded in such manner as to indicate the vote of each individual member of the public body in each item of business, and such minutes shall accurately reflect the matters discussed and acted upon at the meeting.

The minutes of open meetings shall be open to the public inspection within a reasonable time after adjournment or recess of such meeting.

The minutes of executive sessions shall be maintained in a separate executive session minute book which shall not be open to public inspection except upon the affirmative vote of two-thirds (2/3) of the membership of the public body.

SECTION 8. (a) All meetings, or any portion thereof, of such public body shall transpire only after the public has been provided notice as follows: The date, time, and place of any such meeting must be reported to, and be available to, the public at least five (5) days prior to said meeting date; except in the instance of legislative committees or subcommittees during any legislative session when such notice must be reported to, and be available to, the public at least two (2) days prior to said meeting.

(b) Each public body shall give public notice of its schedule of regular meetings at the beginning of each calendar or fiscal year; and such notice shall state the date, time, and place of each such regular meeting; and such notice shall be available at convenient locations in printed form for distribution to the public. Such notice shall be filed with the Secretary of State of Mississippi, or the chancery clerk of the county, or the city clerk of the municipality, or the principal office of such public body.

(c) In addition to the requirements of subsection (b) of this section, each such public body shall file, no later than 9:00 a.m. on Monday of each week, written notice of the meeting schedule for such week with the clerk, secretary, or other designated officer of such public body. Such notice shall be available to the public upon inquiry. The clerk, secretary, or other designated officer of such public body shall make amendments to such weekly notices as required.

(d) Emergency meetings may be called by the presiding officer of any public body by giving notice of such emergency meeting to each member of such public body. The notice shall specify the time and place of such emergency meeting and the business to be transacted. No other business shall be considered at such emergency meeting. In case of such emergency meeting, the presiding officer shall notify the representatives of the newspapers, radio stations, and television stations, if any, located in the county in which the meeting is to be held and which have re-

quested to be so notified of such emergency meetings, of the time, place, and date at least two hours before such a meeting takes place in order that the public shall have respresentatives at the meeting. If there is no newspaper, radio station, or television station in the county, then the presiding officer, when calling an emergency meeting, shall notify representatives of daily newspapers having general circulation within the geographical jurisdiction of the public body, and representatives of at least one radio or television station having general coverage within the geographical jurisdiction of the public body in the same manner as in the case of media representatives located within the county.

SECTION 9. (a) The clerk, secretary, or designated officer of such public body shall maintain a list of citizens of Mississippi who request notification of all meetings, or meetings when certain specified matters will be discussed; and shall provide such citizens reasonable advance notification thereof.

(b) All or any part of the proceedings in any public meeting of any governmental body as defined hereinabove may be recorded by any person in attendance by means of a tape recorder or any other means of sonic reproduction.

SECTION 10. A public body shall not hold a meeting at any place where discrimination on the basis of race, creed, color, sex, age, or national origin is practiced.

SECTION 11. A member of the public shall not be required, as a condition of attendance at any meeting, to register his name, to supply information, to complete a questionnaire, or fulfill any other condition precedent to his attendance; except that a person seeking recognition may be required to give his name and place of residence.

SECTION 12. If any meeting of a public body is willfully disrupted by a person or group of persons so as to render the orderly conduct of the meeting unfeasible, and order cannot be restored by removal of the person or persons who are willfully interrupting the meeting, the presiding officer of the public body may order the removal of such person or group from the meeting and continue in session, or may recess the meeting and reconvene at another location. A public body shall establish procedures for readmitting an individual or individuals not responsible for disturbing the conduct of a meeting. Duly accredited members of the press or other news media except those who participated in a disturbance shall be allowed to attend any meeting permitted by this section.

SECTION 13. Any official action which transpires at a meeting not in substantial compliance with the provisions of this act shall be voidable by a circuit court of competent jurisdiction, and the court may then order appropriate relief.

SECTION 14. (a) The Attorney General of Mississippi, and any public prosecutor or district attorney of competent jurisdiction of this

state, shall enforce the provisions of this act in the appropriate circuit court of this state.

(b) The circuit courts of this state shall have jurisdiction to issue injunctions or writs of mandamus to enforce the provisions of this act, or to render judicial relief pursuant to the provisions of this act, upon application of any citizen of this state.

(c) Any citizen of this state who is successful in enforcing the provisions of this act through such court action shall be allowed all costs and reasonable attorney's fees incurred in the prosecution of such action.

SECTION 15. Each member of a board, committee, commission, or policymaking body who attends a meeting thereof which is held in violation of the provisions of this act, with actual or implied knowledge of the fact that such meeting is in violation hereof, shall be subject to the following:

(a) Upon judicial determination of the first violation, personal liability in the form of a civil penalty in the amount of Two Hundred Dollars ($200.00).

(b) Upon judicial determination of the second violation, personal liability in the form of a civil penalty in the amount of Four Hundred Dollars ($400.00).

(c) Upon judicial determination of the third violation, forfeiture of any further right to serve on the public body for a period of time equal to the term of office such person was then serving. The court determining the merits of any action in connection with any alleged third violation shall receive competent, relevant evidence in connection therewith, and, upon finding as to the occurrence of a separate third violation, unrelated to the previous violations, shall issue its order declaring the position vacant and notify the appointing authority or presiding officer of the public body.

SECTION 16. All laws and parts of laws in conflict with this act are hereby repealed.

STOCK-PURCHASE TRANSACTIONS UPON THE DEATH OF A SHAREHOLDER OF A CLOSELY HELD CORPORATION

Introduction

In Mississippi, as in most states, there exists a wide variety of business entities that can be loosely classified as "close corporations."[1] Ease of management and tax savings are primary reasons for using the corporate form.[2] The stockholders of a close corporation, in their dual role as employees, depend upon the corporate income-generating features to provide their compensation. Since dividends are rarely paid, the stock of a deceased stockholder is often the primary asset of his estate.[3] These very characteristics, however, prevent the stock, as an estate asset, from both carrying its share of the administrative expenses and estate taxes, and providing income to the estate's beneficiaries. The problem is twofold: The stock has little, if any, value as a saleable asset[4] and will most likely generate little dividend income.[5] Surviving shareholders are also affected by the death of a close-corporation shareholder. Since the shareholders are often part of the management team, an untimely death can financially cripple a going concern. As if this were not enough, the surviving shareholders also must be concerned with who will receive the deceased's stock and whether the successor's interests and goals will parallel those of existing management. Because of a liquidity problem the estate may be forced to sell the shares to outside, and possibly incompatible, interests.[6]

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[1]T. Ness & E. Vogel, Taxation of the Closely Held Corporation § 1.1, at 5 (rev. ed. 1972).

Although a precise definition of "close corporation" is difficult, it has several distinguishing characteristics: (1) lack of public ownership; (2) control vested in a small number of stockholders; (3) stockholders and operating executives, to a large extent, composed of the same people; and (4) restricted ownership in that there is no ready market for the stock. *Id.* Often associated with a close corporation is the Internal Revenue Code's definition of a "small business corporation." Section 1371 defines the term in the context of a subchapter S election. Int. Rev. Code of 1954, § 1371 [hereinafter cited as Code]. Section 1244(c)(2) and section 1372 define the term for purposes of allowing an ordinary loss on the stock of such a corporation rather than a capital loss. Code §§ 1244(c)(2), 1372.

[2]The nontax advantages of a corporate form are: (1) centralized management; (2) ease of ownership transferability; (3) perpetual succession; and (4) limited liability. H. Henn, Law of Corporations § 16, at 37 (2d ed. 1970).

[3]A. Hull, Stock Purchase Agreements in Estate Planning—With Forms 23 (1969).

[4]T. Ness & E. Vogel, *supra* note 1, § 5.5(c), at 37.

[5]Nassau, *Buy-Out Agreements in Planning the Estate of a Stockholder-Employee of a Closely Held Corporation*, 2 N.Y.U. 31st Inst. on Fed. Tax. 1029, 1030-31 (1973). If the deceased shareholder were a minority shareholder, the surviving shareholders could squeeze out the estate beneficiaries by voting themselves large salaries. If the deceased were a majority shareholder, the ability to receive benefits is limited by the corporation's ability to generate earnings at a time when the corporation is likely to be in trouble.

[6]This problem is particularly acute if the corporation is a professional corporation or

Despite these almost inevitable problems, few close corporations or their shareholders consider, when forming the corporation, the need to transfer assets out of the corporation upon the death of a shareholder. To meet this need, close-corporation shareholders increasingly are looking to stock-purchase agreements to ensure a ready market for their stock interests upon death.[7] These agreements provide for the purchase of the stock at a fair price upon the death of a shareholder, or upon the happening of some other stated event. The advantages are many. Through such agreements the estate is provided with sufficient liquidity to meet its obligations. Cash, or other readily marketable assets, are provided for the estate beneficiaries who may wish to invest in less speculative assets. Further, stock-purchase agreements largely eliminate potential friction between surviving shareholders and the deceased shareholder's estate or beneficaries. These agreements also preserve the "closeness" of the corporation by preventing outside interests from obtaining the stock.[8]

Stock-purchase agreements generally take one of two forms, although a combination form is sometimes used. Either the corporation itself[9] or the surviving shareholders may purchase the stock. The corporate purchase is termed a stock redemption,[10] while the shareholder purchase is known as a cross purchase. Either method has advantages and disadvantages which must be weighed. A corporate redemption is governed by the tax rules of Subchapter C of the 1954 Internal Revenue Code. Section 301 of the Code provides that distributions by a corpora-

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has made a subchapter S election. A professional corporation's shareholders must be "duly licensed or otherwise legally authorized to render the same or related type of professional services as those for which the corporation was incorporated." MISS. CODE ANN. § 79-9-15 (1972). Upon the death of a shareholder the stock must be transferred to maintain the status of a professional corporation.

All new shareholders must consent to a subchapter S election. Failure to do so will terminate the election. CODE § 1372(e)(1). If the stock passes to a trust, the termination is automatic. *Compare id.* § 1371(a)(2) *with id.* § 1372(e)(3). Termination of a subchapter S status can have disasterous consequences. Treas. Reg. § 1.1375-4(a) (1974).

[7]Stock-purchase agreements also ensure a market in the event of disability or retirement. Kahn, *Mandatory Buy-Out Agreements In Stock of Closely-Held Corporations*, 68 MICH. L. REV. 1, 2 n.2 (1969).

[8]*See generally* 7 Z. CAVITCH, BUSINESS ORGANIZATIONS § 148.02 (rev. ed. 1974) [hereinafter cited as Z. CAVITCH]; A. HULL, *supra* note 3, at 23; Abrams, *Tax Planning for Agreements Disposing of a Shareholder's Closely-Held Stock at Death*, 57 GEO. L.J. 1211 (1969).

[9]MISS. CODE ANN. § 79-3-9 (1972) provides, with certain limitations, for the purchase by a corporation of its own shares. *See* text accompanying notes 35 through 38 *infra*.

[10]In corporate law a "redemption" of stock is a repurchase by the issuing corporation of preferred or special shares of stock which were issued to raise capital with the understanding that they would be redeemed at a more convenient time. Z. CAVITCH, *supra* note 8, at § 147.05(2). The term is used in this comment, however, to refer to a repurchase of stock within the meaning of Section 317(a) of the Code.

tion with respect to its stock[11] shall be treated as a dividend to the extent of earnings and profits of the corporation.[12] Section 302 of the Code, however, allows distributions by a corporation in redemption of its stock to be taxed at the more favorable capital gains rates.[13] Section 303 of the Code also allows exchange treatment for certain types of corporate redemptions. In defining a redemption for section 302 or section 303 purposes, it is necessary to look to section 317(b) which recognizes a redemption "if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock."[14] "Property," the key word, is defined to include not only cash, but other tangible or intangible property as well.[15] Although a transaction may be classified as a redemption, the specific requirement of either section 302 or section 303 must be complied with in order to receive exchange treatment. A cross-purchase agreement is a private contractual arrangement among shareholders creating the right to buy on the part of the surviving shareholders and the obligation to sell on the part of the estate or estate beneficiaries.[16] Sections 301, 302, and 303 do not apply since they refer to corporate redemptions only. The transaction is considered a sale or exchange of a capital asset within the meaning of Section 1222 of the Code[17] and,

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[11]A "distribution with respect to stock" is a corporate distribution made to a person solely in his capacity as a shareholder. T. NESS & E. VOGEL, *supra* note 1, § 10.1(a), at 3.

[12]CODE § 316. Interestingly enough, the term "earnings and profits" is not defined in the Code. It usually is a measure of the corporation's capacity to pay dividends. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.03 (3d ed. 1971).

A dividend is included in the shareholder's gross income and taxed at ordinary income rates.

[13]Section 302(a) of the Code provides that "such redemption shall be treated as a distribution . . . in exchange for the stock."

Under Section 1221 of the Code the stock of a close corporation is usually a capital asset. Under section 1222 a long-term capital gain results from the "sale or exchange" of a capital asset held more than 6 months. Thus, if the stock of a close corporation is held more than 6 months and redeemed under section 302, a long-term capital gain results. Long-term capital gains are taxed at very favorable rates. CODE § 1201. Section 57(a)(9) of the Code, however, classifies one-half of the net long-term capital gain as a tax preference item. Section 56 of the Code imposes a maximum tax of 10 percent on all tax preference items. Nonetheless, capital gains treatment is still very desirable.

[14]This definition of "redemption" is much broader than the corporate law definition. See note 10 *supra*.

[15]"Property" does not include, however, the stock of the redeeming corporation. CODE § 317(a). The term does include debt obligations of the corporation. Rev. Rul. 601, 1968-2 CUM. BULL. 124; Rev. Rul. 289, 1965-1 CUM. BULL. 86.

[16]The agreement need not be mandatory, but may simply create an option to sell or buy. There are, however, certain advantages to a mandatory agreement to dispose of the stock. See Part II(A) *infra*.

[17]Nassau, *supra* note 5, at 1049.

therefore, a capital transaction. A combination plan may provide for purchase by the corporation of part of the deceased's stock and purchase by the surviving shareholders of the balance.[18]

Several considerations, both tax and nontax, must be balanced when choosing between corporate redemption and cross-purchase agreements. One of the primary considerations when using the corporate redemption must be fulfillment of the strict statutory requirements of section 302 or section 303; failure to do so results in dividend treatment under section 301.[19] A cross-purchase arrangement does not suffer from such strict statutory limitations. On the other hand, a corporate redemption is usually much easier to administer, especially if life insurance is the funding medium and there are more than two participating shareholders.[20] Another consideration is the financial ability of the shareholders, as opposed to the corporation, to fund a stock purchase adequately when the need arises.[21] The respective income tax brackets of the shareholders and corporation must also be weighed since any funding will be with after-tax dollars.[22] Finally, in a cross-purchase arrangement the surviving shareholders receive a stepped-up basis in the shares of stock they purchase.[23] Upon a subsequent sale or redemption of the surviving shareholder's stock, less gain will be recognized. In a corporate redemption, however, the basis in each shareholder's stock is not increased, although their proportionate ownership is. These are not the only factors to be considered. Each arrangement masks its own pitfalls, tax or otherwise, which await the unwary shareholder. Only through a clear understanding of each can the shareholder or corporate advisor come to an intelligent decision as to the soundest stock-purchase plan for his situation.

The purpose of this comment is to examine the tax aspects of each

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[18]Usually, in a combination plan the corporate redemption is limited to a section 303 redemption. For a discussion of this type of arrangement, see Part III(F)(4) *infra*.

[19]For a discussion of the tax treatment under Code Section 302 or 303, see Parts II(B)(3) and II(B)(2) *infra*.

[20]In a corporate redemption only one insurance policy is needed for each shareholder. In a cross-purchase arrangement each shareholder must own and pay for an insurance policy on the life of every other shareholder. If there are more than two shareholders, such an arrangement is awkward at best. Use of a trustee may simplify the transaction.

[21]Nassau, *supra* note 5, at 1045.

[22]The corporation can usually fund the plan with cheaper dollars since a 22 percent tax is imposed on the taxable income of a corporation up to $25,000 of taxable income. Thereafter, a surtax of 26 percent is imposed. CODE § 11.

Since, in a shareholder agreement, the funding is usually with dollars obtained from the corporation by way of salary or dividends, under either type of plan the corporation is paying for the transaction. The only difference is the level at which the dollars are being taxed.

[23]ROSS, *Buy-Out Agreement for Transfer of Stock in Family Corporation: Tax Planning*, 1 ESTATE PLANNING 103, 106 (1974). *But see* text accompanying note 232 *infra*.

type of transaction with an eye toward avoiding some of the more subtle tax traps. The comment will first briefly consider some of the more important corporate law requirements applicable to stock-purchase agreements. Because of the profusion of close corporations and because nontax attorneys often fail to realize the role stock-purchase agreements may play upon the death of a shareholder, the comment will be limited to purchases at death.[24] In these situations the corporation rarely has sufficient assets to fully fund a redemption; nor do the shareholders themselves have the necessary funds. Therefore, a substantial portion of this comment will deal with the funding of stock-purchase agreements.[25]

I. Corporate Law Limitations on Stock-Purchase Agreements

Corporate law limitations usually occur in regard to two aspects of stock-purchase agreements. The first involves common-law restrictions on the right of alienation. The second involves statutory and equitable limitations on corporate distributions.

A. Unreasonable Restraints on Alienation

To give effect to the stock-purchase arrangement, the shareholders, either among themselves or with the corporation, enter into a binding agreement to sell and purchase stock upon the occurrence of certain events such as the death or disability of one of the shareholders. These agreements often obligate the corporation or remaining shareholders to purchase the stock, while the departing shareholder, or his estate, is obligated to sell. During the shareholder's life, a first refusal option is vested in the corporation or the other shareholders.[26] Such lifetime restrictions, however, give rise to problems involving unconscionable restraints on alienation.[27] Although there is little statutory guidance for

[24]Stock-purchase agreements are often used in a variety of lifetime situations. For instance, they may be used in bootstrap acquisitions. *See generally* B. Bittker & J. Eustice, *supra* note 12, at ¶ 9.22.

[25]This comment will not attempt to deal with losses on the redemption of close-corporation stock. If the transaction falls within the confines of Code Section 302, the loss may be recognized under Section 165 of the Code. If the deceased shareholder, however, had 50 percent or more of the corporate stock then the loss will be disallowed. Code § 267; McCarthy v. Conley, 341 F.2d 948 (2d Cir.), *cert. denied*, 382 U.S. 838 (1965). The loss deduction may also be disallowed if the terms of the redemption lack economic reality. Treas. Reg. § 1.267(a) (1974); Wickmire v. United States, 116 F.2d 679 (6th Cir. 1941). Section 267 of the Code has been expressly applied to estates. Hanna v. Commissioner, 320 F.2d 54 (6th Cir. 1963), *rev'g* 37 T.C. 63 (1961).

[26]A mandatory stock-purchase agreement can fix the value of the stock for estate tax purposes. *See* Part II(A) *infra*.

[27]Absolute restrictions on the transfer of the stock at the death of a shareholder are generally valid. Kahn, *supra* note 7, at 49.

courts on this question,[28] most have declared absolute restrictions on the lifetime power to sell to be void and unenforceable.[29] A first refusal option is generally held valid[30] and binding as a reasonable restriction on the right of alienation.

To perfect the purchaser's rights, restrictive agreements should be stated in the articles of incorporation[31] as well as embodied in a separate written instrument. In addition, any restrictions must be printed on the face of the stock certificate in order to bind third party purchasers who do not have actual notice of the restrictions.[32]

B. Statutory and Equitable Limitations on Corporate Redemptions

Most states by statute expressly permit a corporation to repurchase outstanding shares of its own stock.[33] In order to protect the rights of corporate creditors and other shareholders, however, certain limitations are placed on a corporation's ability to redeem stock.[34] These limitations are imposed either by statute or by equitable considerations.

The basic operational statute in Mississippi is section 79-3-9[35] which defines the rights of a corporation to acquire its own stock. There are two limitations imposed on corporate repurchases. First, a corporate redemption can only be made to the extent of unrestricted and unre-

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[28]H. O'NEAL, CLOSE CORPORATIONS § 7.06a (1971).

[29]*Id.* § 7.06.

[30]*Id.* §§ 7.06, 7.09; Kahn, *supra* note 7, at 47; Nassau, *supra* note 5, at 1052. Mississippi has not considered this question.

Because of the unique nature of a professional corporation, *i.e.*, the ownership of professional corporation stock is restricted by law, Mississippi allows restrictions on the alienation of shares unless such limitation impairs the capital of the corporation or renders the corporation insolvent. MISS. CODE ANN. § 79-9-19 (1972).

[31]MISS. CODE ANN. § 79-3-105 (1972) requires any provision restricting the transfer of shares to be set forth in the articles of incorporation.

[32]*Id.* § 75-8-204.

[33]Z. CAVITCH, *supra* note 8, at § 147.03. In Mississippi, stock-purchase agreements are a matter solely between the corporation and the shareholder. Jack Cole-Dixie Highway Co. v. Red Ball Motor Freight, Inc., 254 So. 2d 734, 740 (Miss. 1971). *See also* 2 FED. EST. & GIFT TAX REP. ¶ 7412 (1972), for a listing of state laws pertaining to corporate stock purchases.

[34]Originally, statutory limitations only applied to the payment of dividends. In the absence of express statutory requirements, courts refused to extend the limitations to other forms of corporate distributions. Herwitz, *Installment Repurchase of Stock: Surplus Limitations*, 79 HARV. L. REV. 303 (1965). The rationale behind stock repurchase limitations is that such repurchases reduce corporate assets available to meet the credit needs of the corporation while nothing substantial is received in return. Z. CAVITCH, *supra* note 8, at § 147.04(1).

[35]MISS. CODE ANN. § 79-3-9 (1972). MISS. CODE ANN. § 79-3-131 (1972) entitled "Restriction on redemption or purchase of redeemable shares," is not applicable since "redeemable shares" refers to a special class of stock. *See* note 10 *supra*. *See also* Kahn, *supra* note 7, at 50.

served earned surplus. However, if the articles of incorporation so permit or at least two-thirds of all shares entitled to vote do so affirmatively, redemption can be made to the extent of unreserved and unrestricted capital surplus.[36] Second, stock repurchases may not be made if the corporation is insolvent or if to do so would render it insolvent.[37] The effect of the breach of either of these statutory limitations is twofold. Under section 79-3-91 the directors of the corporation are liable to the extent the consideration paid for the shares exceeds the maximum amount which could have been paid. In addition, an agreement to redeem in violation of the statutory limitation will usually be held void and unenforceable.[38]

Stock redemptions may also be declared void under equitable limitations. These usually require a showing of fraud, misrepresentation, bad faith, oppression, or breach of fiduciary duty.[39] In such cases the remedies of injunction, rescission, or damages are available.[40] In the absence of either statutory or equitable limitations, stock purchase agreements are enforceable, although there has been case law to the contrary.[41] Stock-purchase agreements may be enforced by way of specific performance where money damages would not be an adequate replacement for the stock.[42]

Because the application of these limitations cannot adequately be foreseen(especially the statutory restrictions), the parties to the agreement should provide for the possibility of corporate impotence. The

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[36]MISS. CODE ANN. § 79-3-9 (1972) also lists several exceptions to the surplus limitations. None of them, however, are useful in the context of this comment.

[37]*Id.* The burden of proving insolvency is on the party challenging the repurchase. Alcott Co. v. Raphael, 275 F.2d 551, 557 (5th Cir. 1960), *rev'g* 169 F. Supp. 691 (N.D. Miss. 1958).

[38]Mountain State Steel Foundaries, Inc., 18 CCH Tax Ct. Mem. 306 (1959); Z. CAVITCH, *supra* note 8, at § 148.05(2). In a Mississippi case, the supreme court cited *Fletcher on Corporations* for the proposition that such conveyances may be set aside as an infringement on the trust fund doctrine. Cooper v. Mississippi Land Co., 220 So. 2d 302, 307 (Miss. 1969). The court failed to mention Section 79-3-9 of the 1972 Mississippi Code in its opinion. The case, however, dealt with a distribution which, in effect, liquidated the corporation. As such, the distribution was set aside on equitable grounds.

Even though the redemption may be void under state law, it will be tested under federal income tax laws governing redemptions. Theodore O. Wentworth, 32 CCH Tax Ct. Mem. 925 (1973).

[39]Z. CAVITCH, *supra* note 8, at § 147.04(2); *see* Cooper v. Mississippi Land Co., 220 So. 2d 302 (Miss. 1969).

[40]In Mississippi, if creditors of the corporation have been defrauded, an injunction may issue under MISS. CODE ANN. § 11-5-75 (1972). *See* Cooper v. Mississippi Land Co., 220 So. 2d 302 (Miss. 1969).

[41]*E.g.*, Topken, Loring & Schwartz, Inc. v. Schwartz, 249 N.Y. 206, 163 N.E. 735 (Ct. App. 1928) (agreement unenforceable for lack of mutuality because the agreement was conditional).

[42]Z. CAVITCH, *supra* note 8, at § 148.05(3).

agreement should state that in the event of an inadequate corporate surplus, the parties will undertake any steps that are necessary to effectuate the purchase agreement. There are several specific remedies that may be contemplated.[43] One method, should the earned surplus and capital surplus be insufficient to activate a redemption, is to reduce the stated capital of the corporation.[44] The surplus created by this reduction will be a capital surplus[45] and, therefore, available for stock repurchases if the remaining requirements of section 79-3-9 are met.[46] Another method is to revalue the corporate assets, including goodwill, to reflect their true market value. The remaining shareholders also could be required to contribute cash or other property to the corporation to increase the capital surplus.[47] Finally, if the above methods fail to increase the surplus sufficiently, the agreement should require the remaining shareholders personally to purchase the stock.[48] If insurance is used as a funding medium, there generally will be no problem since the insurance proceeds will increase the earned surplus of the corporation.[49] Also, a system of installment payments may be used since only each installment need meet the surplus limitation at the time it is made.[50] Proper planning will virtually ensure the shareholder of redemption upon his death.

II. Taxation of Stock-Purchase Transactions

Although circumvention of the corporate law or equitable limitations will allow a stock purchase to take effect, the best laid plans may come to naught if the tax rules require corporate distributions to be treated as dividends or mandate that a cross purchase be treated as other than a capital transaction. Therefore, a thorough understanding of the tax laws is a prerequisite to proper planning in this area.

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[43]Treasury shares should be canceled as they are redeemed as provided in Section 79-3-135 of the 1972 Mississippi Code. Failure to cancel repurchased shares, which are held as treasury stock, will restrict earned surplus of the corporation. Miss. Code Ann. § 79-3-9 (1972).

[44]Miss. Code Ann. § 79-3-137 (1972) provides for a reduction in stated capital upon a resolution of the board of directors of the corporation with subsequent adoption by a majority of the shareholders.

[45]*Id.* § 79-3-139.

[46]*See* text accompanying note 36 *supra*.

[47]A loan to the corporation, however, will not increase the surplus account of the corporation and may, therefore, be ineffectual. R. Bacon, Corporate Stock Redemption-Basic Rules A-4 (17-5th BNA Tax Man. Port. 1973).

[48]Since the failure to meet statutory limitations would render the agreement void, the shareholders would not be assuming a corporate obligation. *See* note 38 *supra*.

[49]A. Hull, *supra* note 3, at 92; R. Bacon, *supra* note 47.

[50]Mountain State Steel Foundaries, Inc., 18 CCH Tax Ct. Mem. 306 (1959). *But see* Herwitz, *supra* note 34.

A. *Mandatory Stock-Purchase Agreements*

Regardless of the form of the stock purchase, the agreement should require the disposition of the stock upon the death of the shareholder and the purchase of the stock by either the corporation or the surviving shareholders. A mandatory agreement is extremely important in that the purchase price agreed upon will be accepted by the Service for estate tax purposes.[51] This ability to "peg" the value of the stock far in advance of the actual transfer is significant in a number of ways other than the estate tax aspect. First, litigation of the valuation of close corporation stock has averaged over 5½ years from the date of death.[52] During this period, a stock purchase cannot be effectively completed since the final purchase price is unknown. Money paid for the stock may have to be returned or additional amounts may have to be paid. Also, when the value of the stock is known, a section 303 redemption will be easier to effectuate since the percentage limitations[53] can be anticipated. Finally, funding problems can be more actively anticipated and appropriate precautions taken.

In order for a stock-purchase agreement (whether it be a corporate redemption or a shareholder cross-purchase agreement) to be binding on the Service as to valuation, three factors must be present. First, the agreement must establish a price in a bona fide, arms-length transaction.[54] When the parties to the agreement are not members of the same family, such a transaction will be presumed. Otherwise, it is important to show the method used to arrive at the purchase price and to recite the purposes of the agreement.[55] Second, the estate must be obligated to sell the stock upon the death of the shareholder.[56] Finally, the decedent must not have been free to dispose of the stock at any price he chose during his lifetime.[57] Instead, the agreement must provide for at least a

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[51]Although the Service has refused to concede that such agreements will always fix the value of the stock, Treas. Reg. § 20. 2031-2(h) (1974), the case law to date does not support its conclusion. A. HULL, *supra* note 3, at 42.

[52]W. GOLDSTEIN, LIFE INSURANCE—CORPORATE BUSINESS USE A-55 (34-2d BNA Tax Man. Port. 1965).

[53]*See* text accompanying notes 77 through 79 *infra*.

[54]Treas. Reg. § 20.2031-2(h) (1974). The agreement must represent a "bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration . . . ." *Id*. This has been interpreted to mean there must be a business purpose for the agreement. Slocum v. United States, 256 F. Supp. 753 (S.D.N.Y. 1966).

[55]Nassau, *supra* note 5, at 1034. Retention of control by present management is one such purpose that has been accepted. 1959-2 CUM. BULL. 5, *acquiescing in* Orville B. Littick, 31 T.C. 181, 187 (1958).

[56]Although this requirement is not in the Regulations, there is ample case law to support it. Orville B. Littick, 31 T.C. 181 (1958); *see* United States v. Land, 303 F.2d 170 (5th Cir. 1962).

[57]Treas. Reg. § 20.2031-2(h) (1974); *see* Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955).

first refusal option on the part of the corporation or the other shareholders,[58] and the option price must not exceed the death buy-out price.[59] The latter two requirements are based on the theory that during the shareholder's life and at his death the corporate interest had no value to him or his estate in excess of the agreed-upon price. Therefore, his estate should not be taxed on amounts in excess of that value. Because of the advantages detailed above, a mandatory agreement almost always will be more appropriate; hence, the balance of this comment will assume that one is in effect.

B. Corporate Redemptions

1. Purpose and General Operation of Code Sections

Corporate redemptions are taxed primarily under three Code sections governing corporate distributions. These sections are designed to distinguish bona fide corporate redemptions from attempts merely to distribute corporate earnings and profits which would normally result in dividend income.[60] The primary Code section governing corporate distributions is section 301. This section requires corporate distributions to be treated in three ways. First, distributions that are dividends shall be included in the gross income of the shareholder as ordinary income.[61] Dividends are defined in Code Section 316 as distributions by a corporation to the extent of accumulated earnings and profits plus earnings and profits for the current taxable year. Second, to the extent that the distribution is not a dividend, it will be applied to reduce the shareholder's basis in his stock. Third, any remaining distribution will be considered capital gain.[62] Needless to say, if dividend treatment can be avoided it is generally best to do so.

Section 302(a) of the Code, however, provides that corporate distributions in the redemption of its stock[63] will be considered a capital transaction if certain statutory requirements are met. Section 302(d) places the distribution back within the purview of section 301 should the redemption fail to qualify.

Section 301 treatment may also be avoided if the transaction falls

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[58]This would appear to be the most beneficial arrangement since an absolute restriction on lifetime transfers may violate the shareholder's right of alienation. *See* text accompanying notes 26 through 32 *supra*.

[59]Rev. Rul. 60, at § 8, 1959-1 CUM. BULL. 237, 243-44; Nassau, *supra* note 5, at 1033; *see* Brodrick v. Gore, 224 F.2d 892, 896 (10th Cir. 1955).

[60]*See* R. BACON, *supra* note 47, at A-3.

[61]CODE § 301(c)(1).

[62]*Id.* §§ 301(c)(2)-(3).

[63]Whether there is a redemption within the meaning of Section 317(b) of the Code "depends upon all the facts and circumstances, including the intent of the parties." Tabery v. Commissioner, 354 F.2d 422, 426 (9th Cir. 1965).

within the scope of section 303. Designed as a relief measure for closely-held businesses, section 303 provides that dividend treatment will not be accorded redemptions made to pay estate taxes and other expenses if the stock exceeds certain percentages of the estate's value.

Distributions in redemption of stock upon the death of a shareholder will be treated as capital gains if they fall within the limitations of section 303 or meet the strict statutory tests of section 302. Under Section 1014 of the Code, however, property included in the decedent's estate takes a stepped-up basis equal to its fair market value at the date of death.[64] A subsequent sale of the property will result in gain only to the extent the sales price exceeds the new stepped-up basis. Section 1014 has been applied to property held by the decedent's estate;[65] therefore, any sale of stock by the estate will result in income only if the sales price exceeds the value of the stock at the date of death. Since the purpose of section 1014 is to provide a basis in property equal to the value placed on that property for federal estate tax purposes[66] and since a mandatory stock-purchase agreement establishes that value as the redemption price,[67] there will usually be no gain at all upon redemption (or stockholder purchase) of stock from the estate of a deceased shareholder.[68] If any part of the corporate distribution, however, falls within the confines of section 301, that part will be a dividend regardless of the basis of the stock redeemed.[69]

As to the surviving shareholders in a corporate redemption agreement, it has been thought that the redemption could result in a constructive dividend to them. This is premised on the fact that corporate redemptions will increase the proportionate ownership of the remaining shareholders. In *Holsey v. Commissioner*,[70] however, the court held that

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[64]The alternate valuation date may be elected. CODE § 2032.

[65]Cummer v. United States, 62-1 U.S. Tax Cas. ¶ 9344 (S.D. Calif. 1962).

[66]Treas. Reg. § 1.1014-1 (1974).

[67]*See* Part II(A) *supra*.

[68]Gain may result, however, if the agreement is not mandatory and the redemption price exceeds the fair market value of the stock. The excess will be treated as a dividend, compensation, or a gift. If the redemption price is below the fair market value of the stock, the deficit may be considered a gift to the remaining shareholders.

[69]If more stock is redeemed than Section 303 of the Code allows, or if the tests of section 302 are not met, then that portion of the distribution in excess of the limits or not qualifying will be a dividend.

There has long been a question, however, as to the treatment of the shareholder's basis in the stock transferred to the corporation when the payment for the stock is considered a dividend. The Service has stated that there are situations where "proper adjustment of the basis of the remaining stock will be made with respect to stock redeemed." Treas. Reg. § 1.302-2(c) (1974); *see* United States v. Davis, 397 U.S. 301 (1970). *See generally* B. BITTKER & J. EUSTICE, *supra* note 12, at ¶ 9.62.

[70]258 F.2d 865 (3d Cir. 1958), *acquiesced in*, Rev. Rul. 614, 1958-2 CUM. BULL. 920. *See also* Zipp v. Commissioner, 259 F.2d 119 (6th Cir. 1958); Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Rev. Rul. 286, 1959-2 CUM. BULL. 103.

the taxpayer must receive a "direct pecuniary benefit" in order to be in receipt of a dividend under section 116.[71] There are, however, certain instances in which a corporate redemption will be considered a constructive dividend to the remaining shareholders. For instance, if the corporation, by redeeming the stock, discharges another shareholder's obligation under a cross-purchase agreement, then that shareholder will be charged with dividend income.[72] Also, should a redemption fail to qualify under section 302, resulting in section 301 treatment, the surviving shareholders may be in receipt of a constructive dividend if their proportionate interests in the earnings and profits or assets of the corporation are increased by the stock transfer.[73] A constructive dividend may also occur in other situations.[74]

Generally, a distribution of property by the corporation will not result in recognition of income by the corporation. Section 311 of the Code provides that "no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of . . . property." There are, however, several exceptions to the general rule which will mandate recognition of income by the corporation.[75]

2. Section 303

Section 303 ("Distributions in Redemption of Stock to Pay Death Taxes") is the primary section governing redemptions at death. Section 303 was created to aid the estate of close-corporation shareholders when the primary asset was the stock of the corporation. The key to section 303 is that it is automatic in its application. If the requirements are met, then any redemption, as defined in section 317(b), will auto-

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[71]Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Sullivan v. United States, 244 F. Supp. 605 (W.D. Mo. 1965); *see* Zipp v. Commissioner, 259 F.2d 119 (6th Cir. 1958). *But see* Rev. Rul. 286, 1959-2 CUM. BULL. 103, in which the Service stated that a corporate redemption relieving the shareholder of a personal obligation would not result in a constructive dividend if for a valid business purpose.

[72]CODE § 305(c).

[73]For example, where one of two shareholders buys all of the other's stock and has the corporation redeem the purchased shares, the distribution will be a dividend. Aloysius J. McGinty, 38 T.C. 882 (1962), *aff'd*, 325 F.2d 820 (2d Cir. 1963). If the shareholder, however, can convince the Service he was acting as an agent for the corporation, the redemption may qualify under Section 302 of the Code. *See* Erickson v. United States, 189 F. Supp. 521 (S.D. Ill. 1960).

[74]*See* text accompanying notes 166 through 168 *infra*.

[75]Meyer, *Redemption of Stock From an Estate by a Closely-Held Corporation*, 20 U. So. CAL. 1968 TAX INST. 147; Tiger, *How to Plan Stock Redemptions to Pay Estate Taxes—The Problems of Section 303*, 24 J. TAX. 92, 97 (1966). Of course, if the redemption fails to qualify under Section 303 of the Code, sections 302 or 346 may be looked to.

[76]In all situations, the estate should take advantage of section 303 before it distributes the stock since redemptions by estate beneficiaries may cut off the estate's ability to redeem under section 303. *See* 3 CCH 1974 STAND. FED. TAX REP. ¶ 2319.

matically be treated as a section 303 redemption (up to the limits of section 303) even though a section 302 redemption or a section 346 partial liquidation was intended. This is important when planning a distribution, especially when there are two classes of stock or two corporations. The section 303 redemption should always be completed before other action is taken.[76]

Under section 303, if the stock was included in the decedent's estate[77] and the value of the stock exceeded either 35 percent of the gross estate[78] or 50 percent of the taxable estate,[79] a timely distribution in redemption of the stock will be considered to be in exchange for the stock.[80] The amount of the distribution, however, is limited to the sum of the estate, inheritance, legacy, and succession taxes[81] and the amount of any funeral and administration expenses incurred.[82] Interestingly enough, there is no requirement that the distribution actually be used to pay for these expenses.[83]

Because section 303 was also enacted to prevent the forced sale of closely held corporations, Congress felt the need to extend section 303 treatment to instances where the decedent owned the stock of two or more corporations, neither of which qualified by itself, but which taken together did qualify.[84] Accordingly, subsection 303(b)(2)(B) was enacted to provide that for purposes of the percentage requirements the stock of two or more corporations may be added together.[85] To prevent application of this subsection to an investment portfolio, the additional requirement was added that the total shares of each corporation owned

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[77]The percentage requirements must be met as of the date of death. Rev. Rul. 594, 1969-2 CUM. BULL. 44. The decedent must have directly owned the stock. Ownership may not be attributed to him under the constructive ownership rules of Section 318 of the Code. Otis E. Byrd, 46 T.C. 25 (1966).

Stock held by a marital trust may be attributed to the beneficiary of the trust when applying the percentage requirements since the value of the stock in the trust will be included in the beneficiary's estate. Rev. Rul. 616, 1969-2 CUM. BULL. 45. Presumably stock held in any trust would receive the same treatment as long as the beneficiary of the trust has a general power of appointment. Giraud, *Recent Developments in Stock Redemptions*, 21ST TUL. TAX INST. 158, 178-79 (1972).

[78]CODE § 2031 defines the term "gross estate."

[79]CODE § 2051 defines the term "taxable estate."

[80]When applying the percentage tests, the total value of all classes of stock included in the estate may be used even though only one class of the stock is redeemed. Treas. Reg. § 1.303-2(c)(1) (1974).

[81]This includes state estate taxes. *See* Treas. Reg. § 1.303-2(h) (1974).

[82]CODE § 2053 governs allowable funeral and administrative expenses. A widow's allowance, as provided for in MISS. CODE ANN. § 91-7-141 (1972), is not an allowable deduction. Majerus v. Coyle, 245 F. Supp. 214 (N.D. Ill. 1966).

[83]Treas. Reg. § 1.303-2(f) (1974); Meyer, *supra* note 75, at 166.

[84]Report of the Special Advisory Committee on Corporate Distributions, Reorganizations, Section 102 *et seq.* for the House Ways and Means Committee, *reprinted in* BNA Tax. Mgmt. Primary Sources § 303(1954-68)5 (1971).

[85]CODE § 303(b)(2)(B).

by the decedent must represent at least 75 percent of the value of all classes of such stock outstanding.[86]

Although it is clear that an estate may take advantage of section 303, the Code is silent as to who else may have such stock redeemed. The only requirement in the Code is that the stock be in the decedent's estate. Thereafter, the stock may be transferred to other parties. The Regulations limit the redeeming shareholders to a class consisting of those persons who acquired the stock by

> any of the means comprehended by Part III, Subchapter A, Chapter 11 of the Code, including the heir, legatee, or donee of the decedent, a surviving joint tenant, surviving spouse, appointee, or taker in default of appointment or a trustee of a trust created by the decedent.[87]

Under the Regulations, stock may not be redeemed under section 303 from any person who has acquired the stock by gift or purchase from any of the above named persons. A recent case, *United States v. Lake*,[88] however, has held that the limitation as to "purchasers" was not intended to prevent intra-family transfers from qualifying when the redemption proceeds were in fact used to pay the estate taxes.[89] In what appears to be a rather narrow holding, the court stated that where the redeeming shareholder had a "substantial relationship to the estate as a daughter of the decedent and as a beneficiary of the will, [and] she used the redemption proceeds to provide cash for the payment of estate taxes, Regulations 1.303-2(f) should not be construed to cover [the] redemption."[90] Whether redemption treatment will be afforded to other "purchasers" remains to be seen.

The Regulations also state that a section 303 redemption will not be available to a stockholder who acquired the stock from the executor in satisfaction of a specific monetary bequest.[91] This means that when the terms of the will provide for a specific dollar amount to go to a beneficiary and the executor instead distributes assets in kind, then any stock which is part of the substituted assets may not be redeemed from the beneficiary under section 303. A more recent ruling by the Service has provided some relief from this provision. Where the executor had discretionary power under the will to distribute assets in kind, then a redemption from the estate beneficiary may receive the sanction of sec-

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[86]Treas. Reg. § 1.303-2(a) (1974); Meyer, *supra* note 75, at 155. As where there is only one corporation, the attribution of Section 318 of the Code may not be used to meet the percentage requirements. Otis E. Byrd, 46 T.C. 25 (1966).

[87]Treas. Reg. § 1.303-2(f) (1974).

[88]406 F.2d 941 (5th Cir. 1969).

[89]*Id.* at 947.

[90]*Id.* at 950.

[91]Treas. Reg. § 1.303-2(f) (1974).

tion 303.[92] The real danger of this provision occurs when a marital deduction trust is established under a pecuniary formula. Several rulings by the Service have held that such a trust is considered to have been provided for a fixed *dollar* amount.[93] Therefore, stock distributed to the trust may not be redeemed from the trust under section 303. If a section 303 redemption is contemplated, then the will should give the executor the discretionary power to distribute assets in kind. Otherwise the redemption should be from the estate and other assets should be transferred to the trust or other beneficiary.

To fall within the safe harbor of section 303, a redemption must be timely. Unless a petition for redetermination of a tax deficiency has been filed, section 303 redemptions must be made within 3 years and 90 days after the due date of the federal estate tax return.[94] Section 6075 of the Code provides that unless an extension is granted the estate tax return is due within 9 months of the date of death. A 6-month extension is available under section 6081 under certain circumstances. Therefore, in effect, the redeeming shareholder could have a total of 4½ years within which to redeem under section 303.

Although it has been thought that failure to take advantage of the full 9 months to file the estate tax return would result in a shortening of the maximum time available, it now seems clear that the 3-year and 90-day period will run from the due date regardless of when the estate tax return is actually filed.[95] The Service has also ruled that a redemption is timely if made within 3 years and 90 days after a late return is filed.[96]

If the shareholder petitions under section 6213[97] for a redetermination of a deficiency before the tax court, then a section 303 redemption may be made at any time prior to the expiration of 60 days after the final decision.[98] The petition, however, must be bona fide and not solely

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[92]Rev. Rul. 297, 1970-1 CUM. BULL. 66. *See generally* Giraud, *supra* note 77, at 176-77.

[93]Rev. Rul. 270, 1956-1 CUM. BULL. 325, *as amended by* Rev. Rul. 87, 1960-1 CUM. BULL. 287.

[94]The Code arrives at this figure by referring to section 6501(a) as providing the time limitation. Section 6501(a) sets the outer limit on the imposition of tax liability as 3 years from the time the tax return is filed. Section 303(b)(1)(A) of the Code provides a 90-day extension after the expiration of the 3-year period.

[95]Rev. Rul. 47, 1969-1 CUM. BULL. 94. This is in accord with Section 6501(b)(1) of the Code which states that an early return will be considered as having been filed on the due date.

[96]Rev. Rul. 204, 1973-1 CUM. BULL. 170.

[97]CODE § 6213 provides that a petition must be filed within 90 days (150 days if the notice of deficiency is sent to an address outside of the United States) after the notice of deficiency is mailed.

[98]CODE § 303(b)(1)(B). If the redemption is made after the 60-day period, but before the longer period under section 303(b)(1)(A) has run, the redemption will still be timely. Rev. Rul. 246, 1966-2 CUM. BULL. 108.

for the purpose of extending the redemption period.

One of the problems inherent in any stock redemption is the loss of control that accompanies the transaction. Since a section 303 redemption is often necessitated by the lack of liquidity to pay taxes and other expenses, the resultant loss of control is particularly painful. If the estate or beneficiaries own a majority of the stock and wish to retain control, there are two courses they may follow. First, the shareholders could recapitalize the corporation pursuant to a tax-free reorganization under subsection 368(a)(1)(E) and provide for both common and nonvoting preferred stock. Since the preferred stock's basis is determined by reference to the old common stock, and since the old common stock was included in the deceased's estate, a distribution in exchange for the new nonvoting preferred stock will fall within the protection of section 303(a).[99] Second, if during the stockholder's lifetime preferred stock is distributed as a stock dividend, then under section 311 no gain will be recognized on the preferred stock dividend. Although under section 306 the preferred stock will be tainted in that any gain recognized in a redemption of that stock will be treated as a dividend,[100] when the shareholder dies and the stock is redeemed there will be no gain since the basis is stepped-up. Therefore, section 306 stock loses its taint.[101] To take advantage of this second method the preferred stock must be distributed prior to death.

One of the advantages of the strict percentage tests of section 303 is that the redemption can be actively planned, and exchange treatment virtually assured. Because a mandatory stock-purchase agreement will fix the value of the stock, it is possible to predict accurately whether the stock will meet the 35-percent or 50-percent tests. If there is any doubt, then any lifetime gifts of stock should be carefully evaluated. It also may be desirable to make lifetime gifts of other property so that the proportionate value of the stock will be increased. In this regard, use of the marital trust will reduce the taxable estate and possibly render the 50-percent test applicable. If the stock of two or more corporations fails to meet the 75-percent test prior to the shareholder's death, consideration should be given to a merger or other reorganization.[102]

Finally, the redemption agreement should be open-ended in that the corporation should agree either to redeem additional shares or to return some shares upon the final assessment of estate taxes.

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[99]CODE § 303(c); *see* Bilson & Sorgenfrei, *Tax Problems Arising After Death*, 25 U. So. CAL. 1973 TAX INST. 531, 536.

[100]CODE § 306(a)(2).

[101]Z. CAVITCH, *supra* note 8, at § 149.13(1).

[102]Meyer, *supra* note 75, at 155.

3. Section 302

Section 302 will be useful either when the percentage limitations of section 303 cannot be met or when the distribution is in excess of the total estate taxes plus funeral and administration expenses. Section 302 has three tests, any one of which will give rise to exchange treatment under section 302(a). Section 302(b)(1) is basically a carryover of the "essentially equivalent to a dividend" test of the old section 115(g)(1). Section 302(b)(2) is called the "substantially disproportionate" test. Finally, a redemption will be treated as an exchange if the test of section 302(b)(3) is met, where a complete termination of the stockholder's interest is required.[103] Because of the nature of the redemptions covered in this comment, the substantially disproportionate test will rarely be used.[104] The balance of the discussion of section 302 will deal with the other two tests.[105] The tests are applied at the time the shares are in fact endorsed and surrendered.[106] When the stock is placed in escrow until final payment, the tests are applied when the stock is transferred to the escrow agent.[107]

a. Attribution Rules

Since the section 302(b) tests are designed to ensure a real change in the *beneficial* ownership of the corporation, the Code requires stock not directly owned by the decedent's estate or beneficiaries, but owned

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[103]A redemption will also receive exchange treatment if it is of a railroad corporation and pursuant to a plan of reorganization under Section 77 of the Bankruptcy Act. CODE § 302(b)(4).

[104]Since the policies underlying corporate redemption at death require complete termination of the deceased shareholder's interest, a redemption of only a part of the interest will rarely be intentionally sought.

[105]Basically, a three-part test must be met. After the redemption, the redeeming shareholder must own less than 50 percent of the total combined voting power of all classes of stock. CODE § 302(b)(2)(B). Also, there must be more than a 20-percent reduction in the redeeming shareholder's voting power in the corporation. *Id.* § 302(b)(2)(C)(i). Finally, there must be more than a 20-percent reduction in the redeeming shareholder's ownership of common stock in the corporation. *Id.* § 302(b)(2)(C)(ii).

The test is designed to ensure that a redemption will result in a real reduction in the shareholder's interest in the assets and earnings of the corporation. For an exposition of the various formulas that may be used to determine when a redemption is disproportionate, see Z. CAVITCH, *supra* note 8, at § 149.06(2). *See generally* B. BITTKER & J. EUSTICE, *supra* note 12, at ¶ 9.22.

[106]James T. Moore, Sr., 20 CCH Tax Ct. Mem. 1346 (1961). This is true even if the payments are spread out in an installment sale. Alfred N. Hoffman, 47 T.C. 218 (1966).

[107]Oscar L. Mathis, 47 T.C. 248 (1966), *acquiesced in*, 1967-1 CUM. BULL. 2. *But see* Doernbecher Mfg. Co. v. Commissioner, 80 F.2d 573 (9th Cir. 1935), where stock placed in escrow under a conditional sales contract, in which the seller, upon default, could foreclose the agreements in equity and sell the stock, was not redeemed for purposes of meeting the control test of related corporations. *See* note 105 *supra*.

by certain related individuals or other entities, to be attributed to the estate or other redeeming shareholder.[108] But for these "attribution" rules, the tests of section 302(b) would be fairly straightforward. Section 318 sets out the situations in which stock actually owned by one entity will be considered as owned by a related shareholder. Section 318 is so pervasive that stock has been attributed to a related entity which actually owned no stock.[109] Constructive ownership occurs in three situations, but many variations are possible. Under section 318(a)(1), stock owned by a person's spouse, children, grandchildren, or parents is deemed also to be owned by him. Brothers and sisters are not covered by section 318, so stock owned by them or by in-laws is not attributed to the redeeming shareholder. Under section 318(a)(2) stock owned by a partnership, estate, trust, or corporation will be attributed proportionately to a partner, a beneficiary, or a 50-percent-or-more shareholder. Under section 318(a)(3) stock owned by one of the above individuals (partner, beneficiary, etc.) will be constructively owned by the partnership, estate, trust,[110] or corporation. Finally, if a shareholder has an option to acquire stock, the stock will be attributed to the shareholder. In the context of this comment the more important attribution rules are those dealing with estates, trusts, and certain options. The family attribution rules, however, will be considered in a discussion of sideways attribution.

Stock owned by a beneficiary of an estate will be constructively owned by the estate.[111] Although a beneficiary is defined as "any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution,"[112] he must have a direct present interest in property held by the estate or income produced by such property to be a beneficiary under section 318(a)(3).[113] To sever any attribution from a beneficiary to the estate, a full distribution must be made to the beneficiary under the terms of the will and the beneficiary must no longer have a claim arising out of having been a beneficiary.[114]

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[108]CODE § 302(c)(1). The attribution rules were designed to provide predictability for the planner and to "obviate the necessity of a court's scrutinizing family arrangements to determine whether every family member is in fact a completely independent financial entity." Coyle v. United States, 415 F.2d 488, 490 (4th Cir. 1968).

[109]Coyle v. United States, 415 F.2d 488, 490 (4th Cir. 1968).

[110]Stock owned by the beneficiary of a trust will not be attributed to the trust if the beneficiary's interest in the trust is a remote, contingent interest. CODE § 318(a)(3)(B)(i).

[111]Rev. Rul. 103, 1956-1 CUM. BULL. 159.

[112]Treas. Reg. § 1.318-3(a) (1974). A beneficiary may not escape attribution by inserting a trust between himself and the estate. Rev. Rul. 24, 1967-1 CUM. BULL. 75. The stock will be attributed to the estate through the trust even though the trust has not been created at the time of redemption. *Id.*

[113]Treas. Reg. § 1.318-3(b) (1974).

[114]*Id.* § 1.318-3(a); Rev. Rul. 387, 1957-2 CUM. BULL. 225.

There must not be more than a remote possibility that the estate will require the return of any property distributed or that the beneficiary will be liable for any portion of the estate taxes. In *Webber v. United States*,[115] the court held that state law is determinative of whether the beneficiary will be liable for estate taxes after the distribution of the property.[116] To ensure complete termination of the estate-beneficiary relationship, all taxes and other liabilities should be satisfied prior to the distribution and subsequent redemption. Where there is attribution between a trust and the trust's beneficiaries, a valid and binding renunciation of all interest in the trust will be sufficient to sever the relationship.[117]

Ownership of an option will be considered actual ownership for the purposes of section 302. This includes an option to acquire an option.[118] Generally, an option to acquire additional stock from the corporation causes attribution of the treasury stock to the shareholder holding the option.[119] In *Bloch v. United States*,[120] however, the court, by way of dictum, stated that an option to acquire treasury stock should be outside the option attribution rule of section 318. Since nowhere in the Code or Regulations is the term "option" defined, the question is still open. If the redeeming shareholder does have an option to acquire additional stock, the termination of the option at the time of redemption will probably not disqualify the transaction.[121] There is, however, no definitive decision on this point.

Prior to the 1964 amendments,[122] "chain attribution" was used to attribute one person's stock to another even though there was neither an economic nor a family relationship.[123] For example, stock owned by *A*'s spouse would be attributed to *A* under section 318(a)(1) and then reattributed to and between *A*'s parents. Even though there was no direct relationship between *A*'s spouse and *A*'s parents, a redemption from *A*'s parents would fail to qualify because of the stock owned by *A*'s

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[115]263 F. Supp. 703 (E.D. Ky. 1967).

[116]*See* MISS. CODE ANN. § 27-9-33 (1972) which provides for contributions by other beneficiaries out of property they have received from the estate prior to payment of taxes.

[117]Rev. Rul. 211, 1971-1 CUM. BULL. 112. *See generally* Wolfberg, *Understanding the Attribution Rules: A Guide Through A Confusing Area; A Checklist*, 2 N.Y.U. 30TH INST. ON FED. TAX. 1313 (1972).

[118]Treas. Reg. § 1.318-3(c) (1974).

[119]Sorem v. Commissioner, 334 F.2d 275, 280 (10th Cir. 1964); Rev. Rul. 601, 1968-2 CUM. BULL. 124. An "option" in this sense also includes warrants or convertible debentures if the stock may be acquired at the option of the shareholder. *Id.* 125.

[120]261 F. Supp. 597 (S.D. Tex. 1966).

[121]Z. CAVITCH, *supra* note 8, at § 149.07(6).

[122]Act of Aug. 31, 1964, Pub. L. No. 88-554, 78 Stat. 761, 762, *amending* 26 U.S.C. § 318(a) (1954).

[123]B. BITTKER & J. EUSTICE, *supra* note 12, at ¶ 9.21.

spouse. This is called "sideways attribution." Since little justification existed for such attribution,[124] the Code was amended to eliminate sideways attribution from one family member to a nonrelated person by way of a common family member and to eliminate attribution to a shareholder or beneficiary from another shareholder or beneficiary via the corporation, estate, or trust.[125] Not all sideways attribution has been eliminated, however. Of particular importance is the attribution of stock to an estate or trust through a beneficiary. For example, stock owned by the relative of a beneficiary will be attributed to the beneficiary and hence to the estate. The estate will be owner of the stock for redemption purposes[126] even though the actual owner of the stock has no direct relationship to the estate. Since this type of sideways attribution is apt to be present in a close-corporation redemption from the estate of a deceased shareholder, careful attention must be paid to whom the beneficiaries are and their relation to other existing shareholders. Of course, if redemption is limited to section 303, attribution need not be considered.

The Service would prefer to believe that the attribution rules of section 318 are immutable. This may not be the case. In a series of decisions the courts have created the "bad blood" exception which will take a transaction out of section 318 upon a finding of certain facts. If the court is convinced that despite the family relationship, the actual relationship was such that no cooperation or collusion existed between the parties, the presumption of constructive ownership may be overcome.[127]

b. Section 302(b)(1)—Essentially Equivalent to a Dividend

The essentially-equivalent-to-a-dividend test is the only part of the

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[124]S. REP. No. 1175, 88th Cong., 2d Sess. 7 (1964).

[125]CODE §§ 318(a)(5)(B)-(C).

[126]Thomas G. Lewis, 35 T.C. 71 (1960).

[127]Arthur H. Squier, 35 T.C. 950 (1961). *See also* Davis v. United States, 408 F.2d 1139 (6th Cir. 1969), *rev'd*, 397 U.S. 301 (1970); Himmel v. Commissioner, 338 F.2d 815, 820 n.7 (2d Cir. 1964); Bradbury v. Commissioner, 298 F.2d 111, 116-17 n.7 (1st Cir. 1962); Herbert C. Parker, 20 CCH Tax Ct. Mem. 893 (1961). The rebuttal will be greater when there is a substantial minority interest present which has no relation to the redeeming shareholder. Herbert C. Parker, 20 CCH Tax Ct. Mem. 893, 901 (1961). *See generally* Note, *Stock Redemptions from Close Family Corporations Under Section 302*, 47 MINN. L. REV. 853, 865-70 (1963).

In United States v. Davis, 397 U.S. 301 (1970), the Court may have implicitly overruled the *Squier* and *Parker* cases. In a strongly worded opinion the Court held that section 318 is always applicable to section 302 redemptions. The case, however, did not deal specifically with the "bad blood" exception. A case that did was Robin Haft Trust, 61 T.C. 398 (1973), in which the court held that irrespective of the personal relationships among members of a family, the attribution rules of section 318 apply. *See generally* Wolfberg, *supra* note 117, at 1329.

present Code which resembles the old section 115(g)(1). The purpose of the dividend equivalency test was to inquire into the change in position of the shareholder effectuated by the redemption. A dividend does not alter the relative positions of the shareholders;[128] a redemption should. Therefore, the inquiry was into the change in control after the redemption. After the promulgation of the more specific tests of sections 302(b)(2) and 302(b)(3), the dividend equivalency test ceased to play as important a role as it had prior to 1954.[129] Nonetheless, section 302(b)(1) has been looked to as a last resort should the more specific tests fail.

In the 1970 landmark case of *United States v. Davis*,[130] the Court held that "to qualify for preferred treatment under [section 302(b)(1),] a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation."[131] *Davis* and subsequent decisions employing the *Davis* standards require a detailed factual inquiry into both voting power[132] and the net economic effect.[133] There must be a meaningful reduction after the redemption as to both. Under *Davis* and its progeny, it is evident that section 302(b)(1) redemptions are virtually foreclosed and, "[w]ithout an advance private ruling from the Service, there are few situations where a taxpayer can rely with complete certainty on 302(b)(1)"[134] as a means of obtaining exchange treatment.

c. Section 302(b)(3)—Complete Termination

Under section 302(b)(3) there may be exchange treatment if "the

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[128]Bradbury v. Commissioner, 298 F.2d 111, 115-16 (1st Cir. 1962); Keefe v. Cote, 213 F.2d 651, 656 (1st Cir. 1954); Pullman Inc., 8 T.C. 292 (1947).

[129]B. BITTKER & J. EUSTICE, *supra* note 12, at ¶ 9.24.

[130]397 U.S. 301 (1970). *See generally* Giraud, *supra* note 77; Mansfield, *Distributions Not Essentially Equivalent to a Dividend*, 22 U. SO. CAL. 1970 TAX INST. 403; Comment, *The Effect of U.S. v. Davis on Stock Redemptions of Closely-Held Corporations*, 11 WASHBURN L.J. 74 (1971).

[131]397 U.S. at 313. Prior to *Davis* several authorities suggested that in some instances the attribution rules of section 318 need not be applied to section 302(b)(1) redemptions. *See, e.g.*, Bittker, *The Taxation of Stock Redemptions and Partial Liquidations*, 44 CORNELL L.Q. 299, 324 (1959). *Davis* emphatically held that the attribution rules are to be applied in determining if there is a meaningful reduction in the shareholder's proportionate interest. 397 U.S. at 306-07. The possibility, however, of the "bad blood" exception may still be open. *See* text accompanying note 127 *supra*.

[132]Wright v. United States, 482 F.2d 600 (8th Cir. 1973); Brown v. United States, 345 F. Supp. 241, 246-47 (S.D. Ohio 1972).

[133]Wright v. United States, 482 F.2d 600 (8th Cir. 1973); Brown v. United States, 345 F. Supp. 241 (S.D. Ohio 1972); Jones v. United States, 72-1 U.S. Tax Cas. ¶ 9349 (D.N.J. 1972). *See also* Cummins Diesel Sales Corp. v. United States, 323 F. Supp. 1114 (S.D. Ind. 1971); Joseph Miele, 56 T.C. 556 (1971); Ray A. Maher, 55 T.C. 441 (1970); Richard E. Probst, 29 CCH Tax Ct. Mem. 1501 (1970).

[134]R. BACON, *supra* note 47, at A-42.

redemption is in complete redemption of all of the stock of the corporation owned by the shareholder." This section will generally be used to redeem the balance of the stock after a section 303 redemption has been completed.[135] The only requirement is that all of the stock ownership of the redeeming shareholder be terminated. A redemption coupled with a sale of the remainder will satisfy the test. A "complete termination," therefore, does not mean that the shareholder must terminate all interest in the corporation. He may continue to hold or acquire other interests,[136] to serve as an officer or director, or to be a creditor of the corporation.[137]

The major problem in effectuating a complete termination is that the attribution rules of section 318 are applicable in determining if there has been a complete termination of the estate's interest. Stock owned by a beneficiary, either actually or constructively, will be deemed owned by the estate and will prevent complete termination. In this event the estate could distribute the stock to the beneficiary who would redeem the distributed stock as well as his own. The time limitations, however, may prove prohibitive. Unless the beneficiaries join in the stock-purchase agreement or receive the stock pursuant to conditions contained in the will, there is no guarantee they will sell the stock. The problem is even more acute when stock ownership is attributed to the beneficiary through the family attribution rules. Even a distribution by the estate to the beneficiary and a subsequent redemption by him would fail to terminate his entire stock interest.

All three tests now require some change in the voting control of the corporation. Where a shareholder owns both preferred and common stock, with the exception of Section 303 of the Code, the redemption of all or part of the preferred stock can never qualify for exchange treatment unless accompanied by a redemption of the common stock. It was precisely this situation which led three Justices to dissent to a denial of certiorari in Albers v. Commissioner, 73-2 U.S. Tax Cas. ¶ 9730, at 82,376 (U.S. 1973). In a dissenting opinion, Justice Powell, joined by Justices Douglas and Blackmun in calling for a reconsideration of the *Davis* opinion, stated: "[I]t is difficult to see a justification for a result as harsh and inequitable as that often produced by the *Davis* rule." *Id.* at 82,378. *Albers* may be the beginning of the end for the *Davis* rule. Of the three Justices dissenting in *Albers*, only one, Justice Douglas, dissented in *Davis*. Further, both Justice Brennan and Chief Justice Burger filed dissents in *Davis*. This could indicate that the scales have tipped and the *Davis* rule is ripe for reexamination. *Compare* Davis v. United States, 397 U.S. 301, 313 (1970) (Brennan & Douglas, JJ., & Burger, C.J., dissenting), *with* Albers v. Commissioner, 73-2 U.S. Tax Cas. ¶ 9730, at 82,376 (U.S. 1973) (Blackmun, Douglas & Powell, JJ., dissenting).

[135]Zenz v. Qurnlivan, 213 F.2d 914 (6th Cir. 1954). This would occur in a combination cross-purchase and stock redemption situation.

[136]R. BACON, *supra* note 47, at A-24.

[137]The stock may even be held by the redeeming shareholder as security for the redemption price. The possibility that the shareholder will retain the stock upon default will not prevent the redemption from being a complete termination. *See* 1967-1 CUM. BULL. 2, *acquiescing in* Estate of Oscar L. Mathis, 47 T.C. 248 (1966).

Under section 302(c)(2), the redeeming shareholder seeking a complete termination of his interest may waive the family attribution rules if he complies with certain requirements.[138] When sideways attribution from a family member to the beneficiary to the estate is present, however, the Service has consistently refused to allow the estate to waive the family attribution rules as between the beneficiary and the family member-stockholder. The redeeming shareholder, in order to waive family attribution, has to be an individual.[139] In 1973 in *Lillian M. Crawford*,[140] the tax court allowed an estate to waive the family attribution rules thereby severing constructive ownership to the beneficiary of the estate and hence to the estate.[141]

To waive the family attribution rules, the redeeming shareholder must comply with section 302(c)(2) and file the requisite agreement to report any acquisition of an interest in the corporation during the 10-year period following the redemption. Any acquisition of such an interest will terminate the waiver *ab initio*.[142] In *Crawford* both the estate and the beneficiary filed timely agreements.[143] The court indicated, however, that to effectuate a successful waiver only the estate need file the agreement.[144] This would leave the beneficiary free to hold or acquire any future interest in the corporation. It is this point which has caused most of the criticism of the *Crawford* decision, particularly since the estate beneficiaries are often the real parties in interest. Moreover, the benefi-

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[138]The conditions for obtaining relief under Section 302(c)(2) of the Code are complex and designed to guarantee that the exception is limited to situations where all possible steps are taken to assure that constructive control over the stock is not, in fact, present. Therefore, the redeeming shareholder must file an agreement in which he states that he will notify the Service if, within the 10-year period following the redemption, he acquires any interest (including an interest as an officer, director, employee, or consultant) in the corporation. Such interests are forbidden and will result in application of the family attribution rules *ab initio*. CODE § 302(c)(2).

Moreover, a 10-year look-back is required to see if a bail-out situation has been prearranged by intrafamily transfers. *Id.* § 302(c)(2)(B).

[139]Rev. Rul. 388, 1968-2 CUM. BULL. 122; Rev. Rul. 233, 1959-2 CUM. BULL. 106.

[140]59 T.C. 830 (1973).

[141]Whether or not a trust may also waive the family attribution rules is still unclear. In Robin Haft Trust, 61 T.C. 398 (1973), the court indicated that *Crawford* is not automatically dispositive of the issue. Because of a procedural bar, however, the court never reached the issue.

[142]CODE § 302(c)(2)(A).

[143]59 T.C. at 833. Prior to *Crawford*, the Service had held that even when the beneficiary and the estate both filed the agreement required by section 302(c)(2), the family attribution rules would apply. Rev. Rul. 472, 1972-2 CUM. BULL. 202.

[144]62 T.C. No. 17 (May 7, 1974). In Robin Haft Trust, 61 T.C. 398 (1973), the court refused to consider whether a waiver was effective because the parties had failed to file the agreement prior to commencement of litigation on the issue. Therefore, in each instance where a waiver is sought the agreement should be filed by the estate at the same time as the estate tax return. *See also* Fehrs Finance Co., 487 F.2d 184 (8th Cir. 1973); Treas. Reg. § 1.302-4(a) (1974).

ciary of an estate could, under *Crawford*, transfer his stock to a family member (for example, his spouse), have the estate redeem the stock, and then have the family member return the stock to him. Exchange treatment would be received for the benefit of the beneficiary even though his ownership or control remained unaffected.

Until this area is clarified, the practicing attorney should have both the estate and the beneficiary file the requisite agreements and refrain from obtaining any of the forbidden interests in the corporation. Where the estate and the beneficiary both actually own stock, it seems that under the *Crawford* holding a simultaneous redemption of both would be sufficient to receive exchange treatment even though other family members also own stock.

C. Stockholder Cross-Purchase Transactions

Stockholders cross-purchase transactions are not as widely favored as corporate redemptions, even though such transactions are considered to be a sale or exchange of a capital asset.[145] This relative disfavor exists because of the inherent difficulties in funding cross-purchase agreements. The individual shareholder's assets usually do not compare to those of a close corporation. When they do, the stockholders generally would rather not personally obligate themselves under a mandatory agreement. Most such arrangements are, therefore, funded with insurance. Problems with this approach will be dealt with in more detail below.

D. Procedure

1. Filings

When a corporate redemption is undertaken, both the corporation and the shareholder must file information returns detailing the specifics of the redemption. Section 346(a) provides that for the purposes of section 6043 (dealing with corporate returns regarding liquidation, dissolution, termination, or contraction) a section 302 redemption will be considered a partial liquidation. Section 6043 requires that the corporation, within 30 days of either the redemption or the adoption of a resolution to redeem, must file with the district director a return on Form 966 detailing the name and address of the corporation, the place and date of incorporation, the date of adoption of the resolution, and the Internal Revenue district in which the last tax return of the corporation was filed.[146] A certified copy of the resolution must be attached to the return.

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[145]Note 17 and accompanying text *supra*.

[146]Treas. Reg. § 1.6043-1(b) (1974).

In addition, if the corporate distribution is in excess of $600, a separate Form 1099L must be submitted for each redeeming shareholder. This form must recite the name and address of the shareholder, the number and class of shares redeemed, and the total amount distributed to him.[147] Form 1099L, with the transmittal form 1096, must be filed no later than February 28 of the year following the year of the redemption.

As to the redeeming shareholder, the Regulations require that the facts and circumstances of the redemption be reported on his tax return for the year of the redemption.[148] Generally, a separate statement should be attached outlining the circumstances of the redemption with sufficient information so that the Service can ascertain whether the distribution should be regarded as in exchange for stock or as another form of corporate distribution. If a waiver of the family attribution rules is sought, an agreement, as set forth in section 302(c)(2), must be filed. The agreement should be attached to the redeeming shareholder's tax return for the year in which the redemption occurred.[149]

2. Payment of Taxes

Under Section 6151 of the Code, estate taxes must be paid within 9 months of death. Because in close-corporation situations a large part of the estate often consists of the stock of the corporation, a relief provision for the payment of taxes has been provided. Section 6166 allows estate taxes to be paid in 2 or more, not to exceed 10, equal installments if the value of the stock in a closely held business exceeds 35 percent of the gross estate or 50 percent of the taxable estate of the deceased stockholder.[150] The amount of the taxes which may be deferred is limited to that amount of the total taxes due which bears the same ratio as the close-corporation interest bears to the total value of the estate.

If 50 percent or more of the stock is redeemed, the tax is accelerated and becomes due immediately. If a section 303 redemption occurs, the Code provides that for the purposes of this 50-percent redemption rule, the stock redeemed does not count as part of the 50 percent. The stock so redeemed, however, does reduce the stock interest so that a subsequent redemption under section 302 will be measured against the amount of stock after the section 303 redemption. More importantly, for

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[147] *Id.*

[148] *Id.* § 1.302-2(h).

[149] *Id.* § 1.302-4(a).

[150] Because both are designed to relieve hardships when a large portion of the estate consists of close-corporation stock, the requirements for application of section 6166 and section 303 are almost identical. One difference is that under section 6166, to be classified as a close-corporation interest, either 20 percent or more of the voting stock of the corporation must be in the estate or there must be fewer than 10 shareholders. CODE § 6166(c)(3).

the exception to the 50-percent redemption rule to apply, the distribution in a section 303 redemption must be applied before the first installment is due in order to reduce the estate tax liability to the full extent of the distribution.[151] Where there is a series of section 303 redemptions in conjunction with an installment payment of taxes, after each installment payment the total distributions in redemption of the stock must equal or be less than the total installment payments plus other estate tax payments made.[152] For example, if during the first period an installment tax payment is made in the amount of $10,000 and a lump-sum tax payment is made in the amount of $10,000, then a section 303 redemption prior to the payments in the amount of $20,000 will not reduce the estate's stock interest for purposes of the 50-percent redemption rule. If a second redemption is made in the amount of $20,000 and a second installment payment is made in the amount of $10,000, then the total redemption proceeds ($40,000) will exceed the total tax payments ($30,000), hence the second redemption will reduce the estate's stock ownership for purposes of the 50-percent rule. In other words, the entire redemption proceeds under section 303 must be applied to reduce the estate tax liability if section 6166 is used.

III. Funding

Once the taxpayer has established a sound stock-purchase arrangement, he still must face the inevitable problem of funding. The most carefully drawn redemption or stock-purchase plan is worthless unless at the time of execution the requisite "property" with which the redemption will be made is available. There are a number of funding mediums available to the corporation or the shareholder. The proper choice depends on the plan and the particular facts and circumstances of the stock purchase in question. No one method is better than the others. This section will examine the major methods of funding stock purchase plans. First, however, a brief overview will be given to the methods of valuing close-corporation interests.

A. Valuation

The stock-purchase agreement must establish a fixed formula or price for the stock at the death of the shareholder to be binding on the Service when valuing the stock for estate tax purposes.[153] The method used must in some way reflect the actual value of the stock; otherwise, the presumption of an arms-length transaction may be overcome.[154]

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[151] *Id.* § 6166 (h)(1)(B).

[152] Rev. Rul. 188, 1972-1 Cum. Bull. 383.

[153] *See* notes 54 through 59 and accompanying text *supra.*

[154] *See* note 54 and accompanying text *supra.*

Because of the nature of a close corporation, little actual trading in shares takes place. As a result, there is no market for the stock on which to base a price for redemption purposes. For this reason, it is necessary to turn to other sources in setting a fair value for the stock, that is, to sources which are indicative of the price at which the stock would change hands from a willing seller to a willing buyer. There are several indicators of the true value of close-corporation stock. No one method is used exclusively; more often several are applied, each one affecting the base value of the stock in a positive or negative manner.

The agreement may simply recite a buy-out price. Most, however, employ a formula combining several indicators of the true value of the stock. Although a formula agreement is less certain as to the final buy-out price, proper planning will not be impeded since at any given time the price may be accurately deduced. Short-term changes will generally not be very dynamic. The better method, however, is to set a fixed price which will be effective for a stated period of time. Should the parties later fail to agree upon a new fixed price, the agreement could also contain a formula that would be dispositive upon the death of a shareholder.[155]

Regardless of the method used, the value finally determined should reflect two key factors: Book value and earnings capacity. These are universally accepted as the most important considerations when valuing close-corporation stock.[156] Other considerations include the nature of the business, the economic outlook, the dividend-paying capacity, intangibles such as goodwill, other sales of stock and the market price of the stock of comparable businesses.[157] These secondary factors should be used to adjust the base price as determined by the two primary factors. In addition, the existence of any restrictive agreements[158] and the fact

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The Service has also ruled that if the price paid for the stock by the corporation exceeds the fair market value of the stock, the excess will be considered as a gift, or compensation, or possibly even a dividend to the redeeming shareholders. If the price paid is less than the fair market value of the stock, the deficiency will be considered a gift to the surviving shareholders. Rev. Rul. 97, 1959-1 CUM. BULL. 684; Rev. Rul. 614, 1958-2 CUM. BULL. 920. If the agreement reflects the actual value of the stock, this possibility will not occur.

[155]A. HULL, *supra* note 3, at 85-86.

[156]Rev. Rul. 60, 1959-1 CUM. BULL. 237, 242-43; A. HULL, *supra* note 3, at 84; Vass, *Factors That Are Presently Being Emphasized in Valuing a Close-Held Corporation*, 38 J. TAX. 356 (1973).

[157]*See generally* Rev. Rul. 60, 1959-1 CUM. BULL. 237; A. GUILD, STOCK PURCHASE AGREEMENTS AND THE CLOSE CORPORATION (1960); A. HULL, *supra* note 3; 2 FED. EST. & GIFT TAX REP. ¶ 7423 (1974); Martin, *Factors the IRS and the Courts Are Using Today in Valuing Closely-Held Shares*, 36 J. TAX. 118 (1972); Vass, *supra* note 156.

As to special valuation problems when the stock redemption is funded with life insurance, see text accompanying notes 217 through 219 *infra*.

[158]Rev. Rul. 60, 1959-1 CUM. BULL. 237, 243-44.

that the interest to be redeemed is a minority interest[159] will usually be sufficient to adjust the value downward.

Finally, when arriving at a fixed price or when constructing a formula, the nature of the redemption contemplated should be considered. For instance, a section 303 redemption will require that the stock's value exceeds certain percentages of the value of the estate.

B. Cash

The simplest funding medium is cash, generally in the guise of a sinking fund. It is rare, however, that a close corporation, especially a growing one, will have spare cash with which to fund a stock-redemption agreement.[160] Even if the corporation is in a position to accumulate sufficient liquid reserves, the possibility of an accumulated earnings tax is everpresent.[161] The corporation might consider borrowing the requisite funds and pledging the stock as security for the loan.[162] Nonetheless, such action will not increase the surplus of the corporation, hence, a redemption may still be barred by state law.[163]

Individual shareholders may have sufficient cash reserves to fund a shareholder cross-purchase agreement. It would be unwise, though, to rely upon these funds since they are generally accumulated for security and, for one reason or another, may not be available when the need arises.

C. Property

Sometimes the corporation will have other property, usually securities or other readily convertible assets, that it can distribute in redemption of the stock.[164] When appreciated property is distributed, however, the general rule that a corporate distribution in respect of its stock will

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[159]Vass, *supra* note 156, at 358.

[160]Cannon, *Buy-Sell Agreement: Form of Price Received by Seller*, N.Y.U. 24TH INST. ON FED. TAX. 607 (1966).

[161]Section 532 of the Code imposes a tax on "every corporation [with a few exceptions] formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed."

The basic purpose of section 532 is to prevent the use of a corporation as a "savings account" for corporate earnings which should be distributed as dividends. *See generally* B. BITTKER & J. EUSTICE, *supra* note 12, at ¶¶ 8.01 *et seq.*

[162]The fact that the surviving shareholders personally guarantee the loan will not affect the nature of the transaction. Fox v. Harrison, 145 F.2d 521 (7th Cir. 1944); Richard B. Bennett, 58 T.C. 381 (1972), *acquiesced in*, 1972-2 CUM. BULL. 1.

[163]*See* note 38 and accompanying text *supra*.

[164]CODE § 317(a).

not give rise to corporate income may not apply.[165] If appreciated property is distributed, the corporation must recognize income as if it had sold property at the time of the redemption. The character of the gain will depend on the nature of the property in the hands of the corporation and whether the recapture provisions of sections 1245 or 1250 apply.[166]

There are exceptions to the rule requiring recognition, two of which are particularly important in the context of corporate redemptions. If the owner of at least 10 percent of the corporation's stock[167] redeems his entire interest in a section 302(b)(3) redemption, then the corporation need not recognize any gain when appreciated property is distributed. Also, if a redemption qualifies under section 303, then recognition will not be required by section 311.

A corporation may also be required to recognize income if it distributes property in what is, in effect, an anticipatory assignment of income. The income the corporation would have recognized if it had retained the property, for example, accounts receivable, will be imputed to it despite the distribution.[168] Aside from these possibilities, one should not rely on corporate property since, as with cash, there is no assurance it will be available when needed.

D. Debt Instruments

Often a corporation will not be in a position to render full payment for the stock when the redemption occurs. In these situations a debt instrument must be used with payment either to be made in a lump-sum or over a period of time.[169] Regardless of the form, debt obligations

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[165] *Id.* § 311(d). "[A]ppreciated property means any property whose fair market value on the date of distribution exceeds its adjusted basis in the hands of the distributing corporation." Treas. Reg. § 1.311-2(a)(3) (1974).

[166] These provisions will require recapture of part of any gain as ordinary income if the property has depreciated in the hands of the corporation. *See* CODE §§ 1245, 1250.

[167] The redeeming shareholder (presumably the deceased) must have owned at least a 10-percent interest for the 12-month period prior to the redemption. *Id.* § 311(d). The constructive ownership rules of section 318 are not to be applied in determining whether the 10-percent rule is met. Treas. Reg. § 1.311-2(b) (1974).

[168] Treas. Reg. § 1.311-1(a) (1974); *see* Commissioner v. First State Bank, 168 F.2d 1004 (5th Cir. 1948) (distribution of bad debts where collection was made by distributee); Williamson v. United States, 292 F.2d 524 (Ct. Cl. 1961) (distribution of accounts receivable).

[169] Distribution of a corporate obligation will not affect the nature of the transaction since exchange treatment depends on the facts at the time the stock is redeemed. Note 63 *supra*. Also, the issuance of a note, the payment period of which extends past the time limitations of section 303, will not affect the validity of the redemption. Rev. Rul. 425, 1967-2 CUM. BULL. 134; Rev. Rul. 289, 1965-2 CUM. BULL. 86. Finally, creditor status will not affect the waiver of family attribution rules under section 302(c)(2). CODE § 302(c)(2)(A)(i).

are considered "property" within the meaning of section 317(a).[170]

In some cases, though, a debt instrument may be reclassified as an equity interest. Should this occur, the safe harbors of section 302(b) will not apply and dividend treatment will result.[171] Subsequent payments on the "debt" will be deemed distributions in respect of stock and will be treated pursuant to the requirements of section 301.[172]

There is no simple test as to when a debt obligation will be considered an equity interest. As one court has said: "The matter is an essentially factual, often intuitive and subjective determination . . . ."[173] A composit of several factors is usually considered.[174] To aid the taxpayer, the Tax Reform Act of 1969 added section 385,[175] which gives the Service the authority to issue Regulations providing rules for distinguishing between true debt obligations and equity interests.[176]

Although the Service will attempt to value the corporate obligation in the year of distribution and thereby compel the redeeming shareholder to recognize gain,[177] this will not prove to be serious in redemptions at death since little or no gain is recognized.[178] Subsequent pay-

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[170]Joe L. Smith, Jr., 49 T.C. 476 (1968); Rev. Rul. 289, 1965-2 CUM. BULL. 86. *See generally* Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and Proposal*, 26 TAX L. REV. 369 (1971).

[171]Burr Oaks Corp., 43 T.C. 635, 651-52 (1965). Instead, the distribution either will be a recapitalization under section 368(a)(1)(E) or a tax-free exchange of stock under section 1036.

[172]*See* Sansberry v. United States, 70-1 U.S. Tax Cas. ¶ 9216, at 82,860 (S.D. Ind. 1970).

[173]*Id.* at 82,862.

[174]These include: (1) Existence of a note; (2) interest payable; (3) fixed maturity date; (4) whether the debt is secured; (5) whether the debt is subordinated to other creditors (where subordinated the Service has nonetheless recognized it as a debt because it was preferred over shareholders. Rev. Rul. 122, 1973-1 CUM. BULL. 66, 67); and (6) intent of the taxpayer. Harlan v. United States, 409 F.2d 904 (5th Cir. 1969); Sansberry v. United States, 70-1 U.S. Tax Cas. ¶ 9216, at 82, 860 (S.D. Ind. 1970); Rev. Rul. 122, 1973-1 CUM. BULL. 66.

[175]26 U.S.C. § 385 (1970) (originally enacted as Act of Dec. 30, 1969, Pub. L. No. 91-172, § 415(a), 83 Stat. 613).

[176]Five factors must be considered:

> (1) [W]hether there is a written unconditional promise to pay on demand or on a specified date a sum certain . . . and to pay a fixed rate of interest,
>
> (2) whether there is subordination to or preference over any indebtedness of the corporation,
>
> (3) the ratio of debt to equity of the corporation,
>
> (4) whether there is convertibility into the stock of the corporation, and
>
> (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

CODE § 385. Not all of these are, of course, applicable to redemption situations. The Regulations are, as of yet, unissued.

[177]Waring v. Commissioner, 412 F.2d 800 (3d Cir. 1969); Rev. Rul. 402, 1958-2 CUM. BULL. 15; *see* Joe L. Smith, Jr., 49 T.C. 476 (1968); Rev. Rul. 295, 1957-2 CUM. BULL. 227.

[178]Cannon, *supra* note 160, at 612.

ments on the debt will largely be considered a return of basis and therefore nontaxable.[179] Any interest on the note will be ordinary income.[180]

In *Robinson v. Wangermann*[181] the court required corporate obligations incurred in a redemption of stock to be subordinated to creditors should the corporation fail. Therefore, care should be taken to secure the note adequately.[182] If family attribution is waived, however, any secured interest that may result in the return of corporate stock should be avoided since the 10-year rule may be violated and the distribution fail to qualify *ab initio*.[183]

E. Installment Sales

The use of an installment sale under Section 453 of the Code has certain advantages if a corporate note would require gain to be recognized at the time of the redemption. Under section 453, payments may be made over a period of time, and gain will only be recognized as each payment is made.[184] Because the stock receives a stepped-up basis at death, however, the use of an installment sale will generally be of little tax benefit since there is no gain. Nonetheless, such sales are useful in that they provide continuing income to the beneficiaries of the deceased shareholder as well as enable the corporation to preserve its capital while recovering from the loss of a key shareholder.[185] Also, an installment sale will enable the surviving shareholders to spread the payments

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[179] *Id.*; *see* Rev. Rul. 280, 1966-2 CUM. BULL. 304.

[180] If the interest rate is not stated in the note, it may be imputed under the rules of section 483. Treas. Reg. § 1.483 (1974).

[181] 75 F.2d 756 (5th Cir. 1935). *See generally* Dodd, *Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law*, 89 U. PA. L. REV. 697 (1941).

Where the corporation has redeemed the stock for property and then repurchased the property with a note, the courts have stepped the transaction together and subordinated the note. *E.g.*, United States v. General Geophysical Co., 296 F.2d 86 (5th Cir. 1961). *See generally* Herwitz, *supra* note 34, at 324.

[182] These methods include: a pledge of stock owned by the remaining shareholders; a personal guarantee by the remaining shareholders; and a mortgage on corporate assets. R. BACON, CORPORATE STOCK REDEMPTIONS—SPECIAL PROBLEMS A-20 (266 2d BNA Tax Man. Port. 1974).

[183] See text accompanying note 142 *supra*.

[184] The Tax Court has expressly authorized the use of installment sales in corporate redemptions. Estate of Oscar A. Mathis, 47 T.C. 248 (1966).

The nature of the distribution will be determined at the time the shares are redeemed. Subsequent payments in an installment sale will be characterized according to the initial transaction. R. BACON, *supra* note 182, at A-16.

[185] An installment sale is especially advantageous when the corporation does not have sufficient surplus to redeem the stock under state law. The court has held that only each payment, and not the total redemption price, must be covered by sufficient surplus at the time the payment is actually made. Mountain State Steel Foundaries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960). *See generally* Herwitz, *supra* note 34, at 304.

over a period of time, a requirement often necessitated by lack of sufficient liquidity to purchase the stock at one time.

Basically, section 453 requires that for casual sales of personalty the sales price must exceed $1,000, and in the taxable year of the sale the payments, if any, are not to exceed 30 percent of that price. Also, the installment obligation must include an interest rate of 4 percent or interest will be imputed. The existence of a debt instrument is not necessarily controlling,[186] but one should be drawn to help prevent reclassification of the obligation as an equity interest.

An installment redemption (where stock is transferred as each payment is made) is not an installment sale and should always be avoided. This transaction will be considered as a series of redemptions and may result in dividend treatment.[187] Instead, the stock should be redeemed and the payments secured by other measures. As with corporate obligations generally, status as a creditor will not affect the 10-year rule of section 302(c)(2).

If the pay-out period exceeds 15 years, the Service ordinarily will not issue advance rulings as to the tax treatment of the distribution.[188] If it is felt that an advance ruling is required, a pay-out period longer than this must be avoided.

F. Life Insurance

Most stock-purchase plans are funded, at least in part, by some form of life insurance.[189] This is necessitated by the predicament of most close corporations when a substantial stockholder-employee dies. Faced with the necessity of redeeming a large portion of stock at a critical time, most would be required either to borrow heavily or even liquidate if some injection of cash were not received. At least some payment is required initially, if for no other reason than to support the deceased's widow or to pay other expenses. Yet the other forms of funding, with minor exceptions, are for deferred payment. In a cross-purchase transaction most shareholders find themselves in similar circumstances. In these situations life insurance can provide the funds to effectuate the agreement. Moreover, since the life insurance proceeds will increase the

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[186] R. BACON, *supra* note 182, at A-16.

[187] Howard P. Blount, 51 T.C. 1023, *aff'd*, 425 F.2d 921 (2d Cir. 1969). The courts have indicated, however, that a series of redemptions pursuant to a firm and fixed plan to eliminate the stockholder from the corporation may be stepped together as a single transaction. Otis P. LeLeux, 54 T.C. 408, 418 (1970) (held to be essentially equivalent to a dividend); Isidore Hemmel, 41 T.C. 62, 73-74 (1963) (held to be essentially equivalent to a dividend). Cases upholding an installment redemption are rare. *See, e.g.*, Jackson Howell, 26 T.C. 846, 854 (1956) (series of redemptions necessitated by business reasons and there was an "integrated plan to eliminate the [stockholder] completely . . . .").

[188] Rev. Proc. 9, 1972-1 CUM. BULL. 719, 720.

[189] Z. CAVITCH, *supra* note 8, at § 148.03.

corporaton's earned surplus,[190] the shareholders virtually will be assured of redemption treatment under state law regardless of the otherwise limited corporate surplus.

Commercial life insurance is usually one of three distinct types, although there are several variations on each. The three basic classes are whole life or ordinary life, endowment, and term.[191] Whole life policies provide coverage during the lifetime of the insured. Variations occur as to the number of years for which premium payments may be made. For example, on an ordinary life policy, premium payments are made each year for the lifetime of the insured. On a limited-pay policy, premium payments are made for a distinct number of years. In each type of whole life policy, a portion of the premium payment pays for the actual insurance protection, and the balance builds up a cash value in the policy. Endowment policies are similar to limited-payment policies in that at a certain age the face amount of the policy equals its cash value. Prior to the maturity date the face amount will be paid if the insured dies. Both limited-payment life insurance and endowment insurance have higher premium payments than ordinary life insurance since the cash values build up faster. Term insurance pays the face value of the policy upon the death of the insured. There is no cash value build-up in the policy. Term insurance usually is good for a limited time only, although some companies will pay up to age 65. Once this period ends, the policy is automatically terminated and the protection ends. Most insurance companies, however, provide options whereby the insurance may either be renewed (up to a certain age) or converted to another form.

Under a technique known as minimum-deposit funding, a cash value ordinary life insurance policy is purchased by borrowing money to pay for most of the premium each year. The money is borrowed from the policy itself. Each year's cash value can be borrowed at the beginning of the policy year as if the premium had already been paid. The amount actually paid by the policy owner will be the difference between the actual premium and the increase in the policy's cash value. As the policy loan builds up, thereby reducing the face amount of the policy, 1-year term insurance in the amount of the loan is purchased with the policy dividends. This is called the "fifth dividend option" and it enables the insured to maintain full protection.[192] Only mutual insurance companies offer participation in the form of dividends; therefore, if it is

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[190]A. HULL, *supra* note 3, at 92.

[191]*See generally* G. LOVELACE, LIFE AND LIFE INSURANCE (1961); J. MACLEAN, LIFE INSURANCE (1962); D. MCGILL, LIFE INSURANCE (rev. ed. 1967).

[192]When the insured attains approximately the age of 65, the fifth dividend option will be insufficient to purchase term insurance in the full amount of the loan. After the age of 65 there is a gradual decline in the insurance protection. A. HULL, *supra* note 3, at 94.

desirable to use the minimum-deposit funding technique, a mutual insurance company must be considered.

Minimum-deposit insurance is attractive because, if Section 264 of the Code is satisfied, the interest due on the policy loan[193] will be deductible. The interest will be deductible if 4 of the first 7 years' premiums are paid by means other than borrowing.[194] Generally, the first, fifth, sixth, and seventh years' premiums are paid without resorting to borrowing.[195] Thereafter, borrowing may take place each year and the interest on the policy loan will be deductible. After several years the interest deduction may be sufficient to offset a large portion of the premium that must actually be paid by the policy owner.[196] If this method is used, it is necessary to resort to an insurance policy that builds up cash values rapidly in its early years. Many times a limited payment policy offers the best alternative. A policy that offers high dividend values is also preferable.

1. Trusteed Plans

Although usually more desirable in a cross-purchase plan, a trust is also beneficial in many corporate redemption situations. In a trusteed plan, the trustee is the beneficiary of the policy. The premium payments are made by the corporation or the shareholders regardless of actual ownership, which may or may not be vested in the trustee. The stock is usually held by the trustee as an escrow agent,[197] but actual ownership may be vested in him if desired. When a shareholder dies, the insurance proceeds are paid directly to the trustee who transfers the stock to either the corporation or the surviving shareholders and pays the proceeds to the deceased shareholder's estate. Premium payments by the corporation will not be dividends to the trustee if beneficial ownership of the policy is vested in the corporation.[198] Of course, such an interest is pres-

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[193]The interest is added each year to the premium and the total cost is financed by borrowing against the cash values.

[194]CODE § 264(c)(1). Deductions for interest will also be allowed if the indebtedness was incurred in connection with the taxpayer's trade or business. *Id.* § 264(c)(4). Although several cases have recognized stock redemptions as a valid business purpose, *e.g.*, Emeloid Co. v. Commissioner, 189 F.2d 230 (3d Cir. 1951), the Service has refused to recognize this possibility. Treas. Reg. § 1.264-4(d)(4) (1974). There is no definitive decision on this point, however. *See generally* Horin, *Use of Life Insurance to Fund Buy-Out Agreements*, N.Y.U. 28TH INST. ON FED. TAX. 819, 822 (1970); Hutching, *Obtaining Interest Deductions Under Minimum Deposit Plans*, 24 TAX LAW. 101 (1970).

[195]A. HULL, *supra* note 3, at 96.

[196]In some cases the total premium payments will be cheaper than term insurance. *Id.* 95.

[197]In an escrow arrangement the stock is held in a deliverable form. The agent's instructions for disposition of the stock are contained in the escrow agreement. *Id.* 99-101.

[198]Edward D. Lacey, 41 T.C. 329 (1963); Rev. Rul. 184, 1959-1 CUM. BULL. 65.

ent when the corporation, in fact, owns the policy. When the trustee owns the policy, beneficial ownership will be vested in the corporation if the proceeds are to be used to purchase the stock for the corporation.[199]

A trusteed plan is particularly advantageous in a cross-purchase transaction. A trustee ensures that the policy proceeds will be used for the intended purpose. It also serves to simplify funding, especially if there are a large number of insurance policies. Should one shareholder fail to pay the premiums, the trustee could be required to give notice to all the participating parties. Finally, the trustee, as an impartial party, can manage the transaction without becoming involved in any personal conflicts.

The policy proceeds may either be paid directly to the widow of the deceased shareholder, or paid over a period of time if the trustee is a professional fiduciary empowered to invest the proceeds.[200] Most insurance companies will allow trustees to elect from among the various settlement options and pass the payments on to the widow or other survivors.[201]

2. Stock-Redemption Plans—Corporate-Owned Insurance

In a stock-redemption plan, the corporation owns an insurance policy[202] for each shareholder participating in the agreement. Although the beneficiary of a life insurance policy must have an insurable interest in the insured,[203] the consensus is that this relationship is present when the policy "is taken out in good faith to protect the corporation from loss it reasonably expects will be caused by the [stockholder's] death."[204] In addition, the stockholder must be active in the corporation; otherwise it is difficult to imagine how his death would result in any tangible loss to the corporation.[205]

Generally, premium payments are made by the corporation. The

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[199]*See* Rev. Rul. 117, 1970-1 CUM. BULL. 30. *But see* Doran v. Commissioner, 246 F.2d 934 (9th Cir. 1957) (policy never owned by corporation; corporation never assigned policy to trustee; policy was not carried on the books of the corporation as an asset).

[200]Kahn, *supra* note 7, at 36-37.

[201]*Id.* 35.

[202]The corporation should retain all the incidents of ownership to prevent the process from being included in the decedent's estate. *See, e.g.*, Piggot v. Commissioners, 340 F.2d 829 (6th Cir. 1965) (right to change beneficiary); Cockrill v. O'Hara, 302 F. Supp. 1365 (M.D. Tenn. 1969) (intent to give up all incidents of ownership insufficient to prevent inclusion); Kearns v. United States, 399 F.2d 226 (Ct. Cl. 1968) (shareholder retained right to change beneficiary, exercise a conversion privilege, and elect payment options).

[203]D. MCGILL, *supra* note 191, at 505-06.

[204]2 FED. EST. & GIFT TAX REP. ¶ 7414 (1974).

[205]*Id.* Under the definition of a close corporation, this requirement generally will be met. *See* note 1 *supra*.

payments, however, are not deductible as a business expense.[206] Nonetheless, since the corporation is usually in a lower tax bracket than the individual stockholder, significant savings result from using corporate after-tax dollars. Premium payments made by the corporation will not be considered dividend income to the insured stockholder, even though the insured has the right to designate the beneficiary of the policy.[207]

When the beneficiary is one other than the corporation or the estate, there may arise liquidity problems. Often, the widow is designated the beneficiary of the policy, although the actual redemption is from the estate. If the redemption would render the estate insolvent unless it received the proceeds, the corporation would be a subordinated creditor and could not force the stock transfer by way of specific performance or any other remedy.[208] In addition, a release of the shares by the estate may not be possible if the shareholder died intestate. Only when the widow is also the administratrix or executrix of the estate and virtually the sole beneficiary or heir of the estate should the insurance proceeds be payable directly to the widow.

If the beneficiary is a trustee, the same problem may arise unless the trustee is also owner of the stock. If, at the time of the stock transfer to the trustee, the estate was solvent and the agreement was not intended to defraud creditors, it is likely the arrangement will put the stock beyond the reach of general creditors.[209] The trustee may then, pursuant to the requirements of the insurance carrier, arrange for the proceeds to be paid directly to the widow under any of the available options.

Care should be taken if the proceeds are to be paid to someone other than the corporation. Under Section 2042 of the Code, insurance proceeds will be included in the insured's estate if he died possessing any "incidents of ownership" in the policy.[210] The Service, in 1971, issued a

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[206]CODE § 264(a). This section disallows a deduction when the corporation is, directly or indirectly, the beneficiary of the policy. When an independent trustee is the beneficiary, the Service has ruled that premium payments are amounts "paid for the acquisition of a corporate asset (treasury stock)," and are therefore not deductible under Section 164 of the Code. Rev. Rul. 117, 1970-1 CUM. BULL. 30.

[207]Rev. Rul. 184, 1959-1 CUM. BULL. 65. If the beneficiary is one other than the corporation, the right of the beneficiary to receive the proceeds must be conditioned upon the transfer of the stock to the corporation. *Id. See generally* Sanders v. Fox, 253 F.2d 855 (10th Cir. 1958); Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957); Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957). *See also* Horin, *supra* note 194, at 823.

[208]INSTITUTE FOR BUSINESS PLANNING, LIFE INSURANCE PLANNING ¶ 13,806.1 (1974).

[209]*Id.* ¶ 13.806.3. An escrow agreement would be insufficient since title must pass to the trustee to put the insurance proceeds and stock beyond the reach of creditors.

[210]"Incidents of ownership" include the power to "change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc." Treas. Reg. § 20.2042-1(c)(2) (1974).

ruling that insurance owned by the corporation on the life of a majority shareholder would be included in that shareholder's estate since—because of his controlling stock ownership—he had the ability to exercise the incidents of ownership possessed by the corporation.[211] Because of the severe criticism leveled at this ruling,[212] the Service withdrew it in 1972.[213] In its place, regulations were promulgated and adopted clarifying when corporate-owned insurance proceeds would be included in a stockholder's estate.

The Regulations now state that corporate-owned incidents of ownership will not be attributed to a majority stockholder if the insurance proceeds are either paid to the corporation or paid to a third party for a valid business purpose.[214] The net worth of the corporation, however, must be increased by the amount of the proceeds paid to a third party.[215] To the extent that these requirements are not met, the proceeds will be included in the majority shareholder's estate.[216]

When the proceeds are paid to a third party, either in part or in whole, the proceeds must be reflected in the net worth of the corporation. Although it is too early to say exactly what is required when a third party is the beneficiary, it seems that if the proceeds are considered when valuing the corporate stock the requirements will be met. The regulations as to incidents of ownership were further revised by requiring that "consideration . . . be given to . . . proceeds of life insurance policies payable to or *for the benefit of* the company" when valuing close-corporation stock.[217] When read with the new regulations as to incidents of ownership, this indicates that inclusion will only be required when the proceeds are payable to or for the benefit of someone other than the corporation and when the proceeds are not taken into account when valuing the corporate stock.[218] This does not necessarily mandate that such proceeds be added to the stock value in all cases. For instance, if the capitalization of earnings method of valuation is used, the value of any insurance proceeds is presumably already included.[219]

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[211]Rev. Rul. 463, 1971-2 CUM. BULL. 333.

[212]*E.g.*, Comment, *The Inclusion of the Proceeds of Keyman Insurance in the Estate of an Insured Majority Shareholder*, 4 CONN. L. REV. 509 (1972).

[213]Rev. Rul. 167, 1972-1 CUM. BULL. 307.

[214]Treas. Reg. § 20.2042-1(c)(6) (1974).

[215]*Id.*

[216]A minority shareholder need not worry about possible inclusion. Berall, *Use of Life Insurance in Estate Planning—Recent Developments*, 2 N.Y.U. 31ST INST. ON FED. TAX. 1053, 1074 (1973).

[217]Treas. Reg. § 20.2031-2(f) (1974) (emphasis added); *see* Walker, *Proposed Regulations Would Put Proceeds of Corporate-Owned Life Insurance into Estate*, 1 ESTATE PLANNING 20 (1973).

[218]Berall, *supra* note 216, at 1078; Nassau, *supra* note 5, at 1048.

[219]Berall, *supra* note 216, at 1077.

When there is a mandatory stock-purchase agreement, it would also seem that such proceeds need not be added to increase the stock value.[220] Since other increases in the assets of the corporation would not affect the agreed-upon value, neither should the insurance proceeds.

In corporate redemption plans, either ordinary or term life insurance may be used. Some attention has been given to the use of group term life insurance. Because the premiums are deductible by the corporation,[221] the use of such insurance to fund buy-sell agreements has seemed most attractive.[222] Since most states have statutes allowing group insurance proceeds only for the benefit of persons other than the employer[223] and since the premium payments would not be deductible if the corporation were the beneficiary,[224] most such arrangements involve cross-purchase agreements. The Service, however, in a private ruling has indicated that when group term insurance is used to fund a cross-purchase agreement, the premiums will not be deductible by the corporation.[225] In addition, if the proceeds are payable to the surviving shareholder, who will then use the proceeds to purchase the stock, the transaction may fall within the transfer-for-value rule of Section 101 of the Code. If the agreement calls for the use of insurance, it may be deemed an enforceable contractual right to receive the policy proceeds and, therefore, a transfer for value.[226] In such cases, part of the policy proceeds will be ordinary income to the surviving shareholder. If the group insurance proceeds are paid directly to the widow or estate of the deceased shareholder and the stock is transferred to the surviving shareholders, the surviving shareholders will not receive a stepped-up basis in the stock.[227] Despite the initial attractiveness of group term insurance as a funding medium, individual policies should be used. The Service has made it clear that such group arrangements will not receive beneficial tax treatment.

In a few situations the use of life insurance funding may be desirable, but the shoreholder is uninsurable.[228] Should he personally own

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[220]*Id.* 1074; Green & Hobbet, *Tax Problems of Corporations, Stockholders: Corporate Insurance on Majority Shareholder's Life*, 37 J. TAX. 293 (1972); Nassau, *supra* note 5, at 1048.

[221]CODE § 79.

[222]*E.g.*, INSTITUTE FOR BUSINESS PLANNING, TAX PLANNING ¶ 2221.16 (1973); Hopkins, Larkin, Triplett & Webber, *Current Developments in Life Insurance*, 24 U. So. CAL. 1972 TAX INST. 495.

[223]Hopkins, Larkin, Triplett & Webber, *supra* note 222; Advanced Underwriting Division, New York Life, Group Insurance and Business Purchase Agreements, in BUSINESS INSURANCE 84.1 (Diamond Life Bulletins) (1973) [hereinafter cited as Diamond Life].

[224]CODE § 264.

[225]Hopkins, Larkin, Triplett & Webber, *supra* note 222; Diamond Life, *supra* note 223.

[226]INSTITUTE FOR BUSINESS PLANNING, *supra* note 208, at ¶ 13,803.3.

[227]*Id.*

[228]Approximately 1 out of every 20 persons is uninsurable. Ross, *supra* note 23, at 109.

policies on his life, they may be transferred to the corporation without running afoul of the transfer-for-value rule of section 101.[229] A similar transfer to the other shareholders or a trustee would and should be avoided.

3. Cross-Purchase Plans—Shareholder Owned Insurance

In a cross-purchase agreement each shareholder owns and pays premiums on policies insuring the lives of the other shareholders. This type of arrangement can be cumbersome when more than two shareholders are involved. If there are four shareholders, each must own and pay for three policies—one for each of the other shareholders. In the long run, however, the funding of a cross-purchase arrangement may be more equitable than a stock-redemption plan. In a corporate redemption plan, any premium difference will weigh more heavily on the majority stockholder due to the larger interest of a majority shareholder, the shareholder's age, or his health. The majority shareholder, however, has the least to gain. For instance, a 60-percent shareholder will bear, in effect, 60 percent of the cost of the premiums on a policy on his life. In terms of benefit, however, the 40-percent shareholder, who bears only 40 per-cent of the cost, will become a 100-percent owner when the majority shareholder dies. The 60-percent shareholder, if the 40-percent shareholder dies first, will be no better off since he already owns a controlling interest. On the other hand, in a cross-purchase transaction, the minority shareholder would bear the total cost of the higher premiums, but would receive a correspondingly greater benefit should the majority shareholder predecease him. Should the minority shareholder die first, his estate will have use of the cash value in the larger policy to offset his higher outlay.

The major problem, however, with cross-purchase insurance occurs upon the death of one of the shareholders. The surviving shareholders' respective interests are increased. Correspondingly, more insurance is needed to fund any subsequent stock purchases. Although this need could be effectuated by a transfer of the policies on the surviving shareholders' lives from the deceased's estate to the surviving shareholders, the transfer-for-value rule of section 101 prevents such a transaction. The problem may be partly solved by transferring the policies owned by the deceased to the corporation, thereby taking the transfer outside the scope of section 101. Subsequent stock purchases would be partly corporate redemptions and partly stockholder purchases.[230]

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[229]CODE § 101(a)(2)(B) exempts a transfer of a policy to a corporation of which the insured is a shareholder or officer.

Possible in-contemplation-of-death problems should also be considered. *See generally* Berall, *supra* note 216.

[230]In any event, the corporation should not use the insurance proceeds to help effec-

Premium payments in a cross-purchase plan should be made by each individual shareholder. Should the corporation pay the premiums, a constructive dividend would result.[231] By increasing the compensation of each shareholder, the necessary funds generally can be provided. The increased compensation, of course, would be deductible as a necessary business expense.

One of the principle benefits under a cross-purchase agreement is the stepped-up basis each surviving shareholder receives in the newly acquired stock. Subsequent sales or redemptions of the stock will result in less gain because of the increased basis. In order to ensure that the surviving shareholder will receive an increased basis, insurance proceeds should be payable to the purchasing shareholder and not the estate or widow of the deceased shareholder.[232] Otherwise the increased basis may be disallowed.

4. Combination Plans—Split-Dollar Insurance

Although occasionally viewed with disfavor,[233] a combination plan is highly attractive when, because of the attribution rules or other limitations, a complete redemption under section 302 is not possible. In these situations, the corporation may redeem the stock to the extent of section 303 with the balance being purchased by the surviving shareholders.[234] These arrangements may be funded by the use of split-dollar insurance. In this arrangement, the insurance policy is owned jointly by the corporation and the stockholder. Each contributes a portion of the premium payment and receives a portion of the policy proceeds. The corporation's share of the proceeds is equal to the cash value in the policy at the time of death. The surviving shareholders receive the balance.

There are two ways to establish joint ownership. First, the employee may own the policy and make a collateral assignment of it to the corporation securing repayment from the policy proceeds of the amounts advanced by the corporation for partial payment of the premiums. Sec-

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tuate the cross-purchase agreement. Any use of corporate funds would be considered a constructive dividend to the surviving shareholders. *See* text accompanying note 71 *supra*.

[231]Gibbs v. Tomlinson, 362 F.2d 394 (5th Cir. 1966).

[232]Paul Legallet, 41 B.T.A. 294 (1940); Nassau, *supra* note 5, at 1051. *But see* Victor G. Mushro, 50 T.C. 43, 50 (1968) ("[T]he partners' real intent was to have either the surviving partners or the partnership receive the insurance proceeds. When the partners named their wives beneficiaries of the policies . . . they were only creating a security device . . . .").

[233]Comment, *Essentials of Corporate Stock Redemptions Under Section 303*, 1972 WIS. L. REV. 1153.

[234]*See generally* Bradford, *Estate Transfer and the Family-Owned Closely-Held Corporation*, 112 TRUST & ESTATES 478 (1973).

ond, the employer owns the policy; an endorsement is attached stipulating that the proceeds are to be paid to the employer to the extent of the cash value in the policy. Because Mississippi and most other states have a law prohibiting loans by corporations to certain employees,[235] the endorsement method must be used. Upon the death of the shareholder, that portion payable to the corporation is used to fund a section 303 redemption. The balance is paid to the surviving shareholders to fund a cross-purchase agreement.

Normally, the corporation would pay that portion of the premium equal to the current year's increase in the policy's cash value.[236] The shareholders would pay the balance. Because of the tax treatment often resulting from the standard arrangement, several hybrids have been developed. Each year the shareholder must recognize income on the value of the economic benefit accruing to him in excess of that portion of the premium he actually pays.[237] The "economic benefit" is the current insurance protection. The "current insurance protection" is the difference between the face amount of the policy and the cash value at the end of the policy year.[238] To determine the amount of the income the employee must report, it is necessary to ascertain the cost of the pure insurance and then subtract what he actually pays. The Service has developed a table, the PS-58 Table, from which the cost may be ascertained.[239] To the extent the PS-58 cost each year exceeds that portion of the premium he paid, the employee must recognize income.[240]

In the early years, because the employee/insured is relatively young, the PS-58 cost will be correspondingly small. During this period, the employer's contribution, based on the increase in cash value, will also be low because most policies do not build up cash values until after several years. This means that the employee will pay a large portion of the premium, far in excess of the PS-58 cost. Later on, as the employee's portion of the premium payments decrease (and the employer's increases), and the PS-58 cost increases, he must recognize income. No carryover is allowed from the earlier years when his payments far exceeded the PS-58 cost.[241] Because of this, various modified

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[235]MISS. CODE ANN. § 79-3-89 (1972).

[236]No deduction is allowed on that portion of the premium paid by the corporation. Rev. Rul. 328, 1964-2 CUM. BULL. 11.

[237]*Id.*

[238]Berall, *supra* note 216, at 1058.

[239]The PS-58 Table is found in Rev. Rul. 747, 1955-2 CUM. BULL. 228. The insurer's rate for individual, initial issue, 1-year term insurance policies may be used if lower than the PS-58 cost. Rev. Rul. 110, 1966-1 CUM. BULL. 12, 14. The insurer's 1-year rates must be available for separately issued policies. Rev. Rul. 154, 1967-1 CUM. BULL. 11.

[240]Although the PS-58 cost is considered income to the shareholder, the corporation may not deduct the cost as compensation. Rev. Rul. 328, 1964-2 CUM. BULL. 11.

[241]Hopkins, Larkin, Triplett & Webber, *supra* note 222, at 535-36.

split-dollar plans were conceived. Each is designed to ensure that the employee's payments roughly equal the PS-58 cost; therefore, there is little or no income to the employee.

There are three variations on the standard split-dollar plan.[242] One provides that the employee's cost never exceeds the PS-58 cost; the employer pays the balance. In the second plan, the employer pays all of the premium and the employee merely reports the PS-58 cost as income. Under both plans, until the cash value builds up, the employer will have funds outstanding which are not secured by the cash value of the policy. A change in the endorsement, however, can ensure that the proper amount of proceeds is payable to the corporation should the shareholder die. A third plan calls for the employer and employee to make level payments each year. Although the employee will still pay more during the early years than the economic benefit accruing to him, the disparity is not as great as under the standard arrangement.

As with any other insurance, split-dollar insurance may also take advantage of minimum deposit funding to decrease the cost.[243] If the fifth dividend option is used to keep the face value of the policy constant, the PS-58 cost of the additional 1-year term insurance must be added to the PS-58 cost of the policy when determining how much income the employee must recognize.[244]

Policy proceeds are treated the same for income tax purposes as ordinary life insurance proceeds. That portion of the proceeds available to the corporation should be considered when valuing the corporate stock to avoid its inclusion in the insured's estate if he is a majority shareholder.[245] Because the right to designate the beneficiary of the policy is considered an incidence of ownership,[246] the insured shareholder should not retain the right. The most advantageous arrangement would be to have the corporation own the policy (the endorsement method) and to vest the right to designate the beneficiary in the shareholders who are also the beneficiaries. The insured should retain no rights whatsoever as to his own policy.[247]

CONCLUSION

Stock-purchase plans are an invaluable tool that should always be

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[242]*Id.* 536.

[243]*See* text accompanying notes 192 through 196 *supra*.

[244]Rev. Rul. 110, 1966-1 CUM. BULL. 12; Berall, *supra* note 216, at 1060.

[245]*See* text accompanying notes 214 through 220 *supra*.

[246]Treas. Reg. § 20.2042-1(c)(2) (1974).

[247]Should the insurance proceeds be included in the insured's estate there is some authority that any stock subject to a mandatory cross-purchase agreement is excluded from the estate pro tanto. Ray E. Tompkins, 13 T.C. 1054 (1949), *acquiesced in*, 1950-1 CUM. BULL. 5.

considered when forming a close corporation. When a substantial shareholder dies, there is virtually no other way, short of liquidation, by which the stock can be transformed into readily available assets for the payment of taxes and creditors or for providing support to the estate beneficiaries. Unfortunately, little throught is generally given to this aspect of corporate ownership.

Although no one plan is always better than the others, it is this author's feeling that in a majority of situations a corporate redemption plan is the most advantageous. Insurance funding should be used where feasible; minimum funded insurance offers a good compromise between the economy of term and the stability of ordinary life insurance. Where family or other attribution rules render a complete corporate redemption hazardous, the combination redemption and cross-purchase transaction should be considered. Regardless of the method used, the agreement should be reevaluated each year by the attorney and shareholders, so that necessary adjustments may be made when required.

William Steene Painter

THE DOCTOR-MERCHANTS: AN ANALYSIS OF THE LAWS GOVERNING PHYSICIAN CONTROL OF THE SOURCES OF SUPPLY OF MEDICAL PRODUCTS

If the public believes that caveat emptor has been substituted for the oath of Hippocrates, the whole physician-patient relationship changes.[1]

Introduction

In *North Dakota State Board of Pharmacy v. Snyder's Drug Stores, Inc.*,[2] the Supreme Court held that the due process clause does not prevent a state legislature from statutorily prohibiting certain persons and corporations from owning pharmacies. The significance of *Snyder's* lies in the Court's overruling an old case[3] which had discouraged inquiry at the state level into physicians' conflicts of interest. *Snyder's* revived a controversy concerning medical conflicts of interest: Should physicians be prohibited from serving in the dual capacity of healer and merchant?[4]

The controversy arises when a medical practitioner owns an interest in a pharmacy or optical dispensary, dispenses medical products from his office, owns an interest in a drug company, or receives payments in consideration for the referral of his patients to dispensers of medical products. This comment is not offered as an indictment of the medical profession. Self-regulation has enabled physicians to maintain commendably high ethical standards. In fact, this comment is aimed only at the medical practitioners who have strayed from these professional standards. The term "doctor-merchants"[5] describes dealers in medical products who also practice medicine and who have combined their dual role to the detriment of their patients and competing suppliers of medical goods.[6]

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[1]Address by Dr. Walter Modell, American Association for the Advancement of Science, 1962, in M. Mintz, By Prescription Only 307 (rev. ed. 1967).

[2]414 U.S. 156 (1973).

[3]Louis K. Liggett Co. v. Baldridge, 278 U.S. 105 (1928).

[4]A thorough treatment of medical conflicts of interest and the legal problems involved therein may be found in F. Fletcher, Market Restraints in the Retail Drug Industry pt. III (1967); M. Mintz, By Prescription Only ch. 15 (rev. ed. 1967); Hammel & Myers, *Physicians Owned Pharmaceutical Companies — A Wrong Without a Remedy*, 21 Food Drug Cosm. L.J. 412 (1966); Note, *Physician Ownership in Pharmacies*, 41 Notre Dame Law. 49 (1965) [hereinafter cited as *Physician Ownership in Pharmicies*].

[5]The term "doctor-merchants" was coined by Senator Hart to describe a particular type of medical practitioner that the Senator has attempted for 10 years to legislate out of existence. 116 Cong. Rec. 34254 (1970) (remarks of Congressman Burlison).

[6]Pharmacists' organizations have been the most active proponents of legislation that would prohibit physicians from engaging in the medical products business. The materials provided by such organizations which appear in this comment must be read with the knowledge that pharmacists stand to gain much from prohibitive legislation in terms of

I. Doctor-Merchants

A. *Physician Ownership of Pharmacies*

When a physician owns a pharmacy in the area where he conducts his medical practice, he has the opportunity to control its profitability and his income. Hearings conducted by the Senate Subcommittee on Antitrust and Monopoly in 1964 disclosed several ways in which doctor-merchants have "steered" patients to doctor-owned pharmacies.[7] These practices, which have been declared unethical or have been disapproved by the American Medical Association (AMA), include: prescribing medications in a code which a doctor has disclosed to only one pharmacist, telephoning the prescription to the doctor's pharmacy and telling the patient that his medication may be picked-up there, using some sort of pneumatic tube to send prescriptions to a nearby doctor-owned pharmacy, using prescription blanks printed with the name of the doctor's pharmacy, and simply telling the patient where he should get his prescription filled.[8] In addition, the doctor-merchant can steer patients to his pharmacy by cleverly locating it so close to his office that patients will patronize it as a matter of convenience. This practice is especially effective in medical clinics where the clinic-owned pharmacy is located so that patients must pass it before leaving the building.

The particular evils of physician ownership appear not when a physician merely owns a pharmacy but when he steers his patients there. Doctor-merchants often overprescribe or unnecessarily prescribe when they know patients will be purchasing drugs from their pharmacy,[9] and the patient often is sold inferior and unknown products at exorbitant prices by employees not authorized to dispense drugs. When patients are denied the right to freely choose a pharmacy, other drugstores can no longer compete for a fair share of the doctor's prescription-carrying patients.[10]

Similar problems occur when physicians rent space to a pharmacy.

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an increased share of the prescription drug market and added professional status. *See Hearings on S. 1575 Before the Consumer Subcomm. of the Senate Comm. on Commerce*, 91st Cong., 2d Sess., ser. 91-81, at 26-54, 79-103 (1970) (statements of William E. Woods, National Association of Retail Druggists (NARD) and Dr. William Apple, American Pharmaceutical Association (APhA)) [hereinafter cited as *1970 Hearings*].

[7]*See Hearings Pursuant to S. Res. 262 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 88th Cong., 2d Sess. (1964) [hereinafter cited as *1964 Hearings*].

[8]Letter from Paul Rand Dixon to Senator Hart, July 8, 1965, in *Hearings on S. 260 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 90th Cong., 1st Sess. 22-24 (1967) [hereinafter cited as *1967 Hearings*]; *Physician Ownership in Pharmacies* 53-54.

[9]Statement of William E. Woods, Washington Representative, NARD, *1970 Hearings* 32-34.

[10]*Id.*

This practice has become popular because it allows doctors to avoid being accused of the exploitative practices which usually accompany the ownership of a pharmacy.[11] Leasing space to a pharmacy is attractive because of percentage lease arrangements; space has been leased for as much as 50 percent of the pharmacy's gross receipts.[12] Where such a lease exists, the doctor-merchant is again tempted to steer his patients. Doctor-merchants can also profit by leasing space to a pharmacy at an excessive flat-rate rental.[13] Under this type of arrangement, a doctor-merchant derives no benefit from sending his patients to the pharmacy; however, patients are nevertheless injured because the cost of their medication will reflect the pharmacist's high rent.

Current statistics on the number of doctor-owned pharmacies and clinic pharmacies in Mississippi are unavailable.[14] In 1970, however, it was estimated that at least 5 percent of the Mississippi pharmacies were owned by physicians.[15] This figure is substantial enough to warrant a study of Mississippi doctor-merchants by appropriate state agencies.

B. Doctor Dispensing

In England, physicians and pharmacists periodically clash over the dispensing of drugs and devices by physicians.[16] The controversy frequently occurs in this country with equal intensity. In large metropolitan areas, it is unlikely that the few dispensing doctors have any measurable effect on the profitability of pharmacies.[17] In less populated areas, however, such arrangements could drive other pharmacies out of business. It is not contended that doctor-dispensing has grown to such proportions that other pharmacists are altogether going out of the prescription business, but doctor-dispensing is prevalent enough to support a number of firms who do nothing but sell drugs, medical devices, and surgical products to medical practitioners.[18] It has been estimated that physicians dispensed $400 million worth of drugs in 1973.[19]

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[11] *See* Statement of Dr. Harold D. Caylor, American Association of Medical Clinics, *1970 Hearings* 54-68.

[12] Statement of Martin Winton, *1970 Hearings* 51.

[13] Flat-rate rentals of $40 per square foot per year have been reported in areas where space is usually rented to a pharmacist for $10 per square foot per year. Statement of Carl Roberts, Director of the APhA Legal Division, *1970 Hearings* 85.

[14] Letter from H.W. Holleman, Executive Secretary of the Mississippi State Board of Pharmacy, to Thomas C. Gerity, July 10, 1974, on file at the *Mississippi Law Journal.*

[15] Statement of William E. Woods, Washington Representative, NARD, *1970 Hearings* 50.

[16] *Dispensing Doctors*, 1973 THE LANCET 604.

[17] *See* Statement of Marvin Sandler, National Association of Mail Order Pharmaceutical Suppliers, Inc., *1970 Hearings* 72.

[18] *Id.* 68.

[19] Garcha, *The Hidden Competition: Those Doctor-Dispensers of Drugs*, DRUG TOPICS, Oct. 15, 1973, at 20.

Both individual physicians and the American Medical Association justify physician dispensing by claiming that it is an integral part of the doctor-patient relationship. They believe that the physician should have the alternative of dispensing if he feels that it is in his patient's best interest.[20] Dispensing allows the physician to ensure that his patient receives the prescribed medication and enables him to check his patient's condition before granting a refill.[21] Dispensing physicians, it is further argued, are able to reduce the cost of drugs to less affluent patients by dispensing lower cost generic medications.[22] Doctor-dispensing also keeps the cost of drugs down and prevents pharmacies from taking monopoly profits which would otherwise be available to them.[23]

Unfortunately, injury to competition is not the only adverse effect to be juxtaposed against the possible benefits. Some doctors delegate the dispensing function to personnel who are not qualified to dispense medications.[24] Often, accurate records of dispensed drugs are not kept.[25] Patients are denied the right to buy their medication at local pharmacies.[26] Drugs are dispensed in paper envelopes and other containers not designed to protect them from elements which cause deterioration and drug ineffectiveness.[27] Prescription-labeling requirements often are not satisfied.[28] There have even been reports of doctors selling drug samples given them by representatives of drug companies.[29] These abuses outweigh the benefits of doctor-dispensing.

Many doctors dispense drugs properly and believe that they are helping their patients. It seems, however, that a doctor is justified in dispensing drugs only when local pharmacies are not available to his patients.[30] The present shortage of physicians indicates that most doctors should be too busy rendering medical care to have the time to act in a dual role of physician and pharmacist.

C. Dispensing Eyeglasses

Ophthalmologists and optometrists[31] are subject to the same criti-

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[20]Statement of Marvin Sandler, *1970 Hearings* 69,71.

[21]*Id.* 69.

[22]*Id.*

[23]*Id.* 74, 77.

[24]Statement of Philip Sacks, Vice Speaker of the House of Delegates, APhA, *1970 Hearings* 82; Statement of William E. Woods, Washington Representative, NARD, *1970 Hearings* 30.

[25]Statement of William E. Woods, *1970 Hearings* 30.

[26]*Id.*

[27]*Id.*; Statement of Philip Sacks, *1970 Hearings* 82.

[28]Statement of Philip Sacks, *1970 Hearings* 82.

[29]Statement of William E. Woods, *1970 Hearings* 30.

[30]*See* Part II *infra*.

[31]An ophthalmologist is a duly licensed physician who specializes in the care of

cisms as physicians when they own an interest in an optical shop, dispense eyeglasses from their offices, or lease space to an optician. Eye doctors profiting from the sale of glasses pose a threat to the economic viability of independent opticians and are subject to the temptation to write unnecessary prescriptions.[32]

While the greatest conflict of interest appears where eye doctors, directly or indirectly, dispense glasses to their patients, eye doctors have been disciplined for entering into rebating arrangements with opticians.[33] In a typical rebating arrangement the optician will pay an agreed percentage of the price he receives from the sale of glasses in consideration for the referral of a patient.[34] Probably the most notorious rebate scheme is the "charge-and-send plan" which the Justice Department has declared to be of doubtful legality.[35] Under this arrangement, the eye doctor diagnoses a need for glasses, writes a prescription, collects a professional fee, and sends the patient to an optician. The optician aids the patient in selecting frames then makes and fits the glasses. The finished product is sent to the eye doctor who gives the glasses to the patient and collects the consumer price. The eye doctor pays the optician the wholesale price and a "fitting fee", retaining the difference. In this arrangement, both the optician and the eye doctor profit from the sale of glasses; the patient loses.

The illegality of rebating schemes arises because patients are exploited. In addition to the extra cost, rebating arrangements harm patients because they tempt eye doctors to prescribe unnecessary eyeglasses. The same potential for abuse is present when an eye doctor is able to profit from the sale of glasses in his office or from an optical shop which he owns.

D. Drug Repackaging Companies

A drug repackaging company purchases drugs from manufacturers in large quantities at discount prices. These companies do little more

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the eyes. An optometrist examines eyes for refractive error, recognizes (but does not treat) diseases of the eye, and fills prescriptions for eyeglasses. The optician is an artisan qualified to grind lenses, fill prescriptions, and fit frames.

Williamson v. Lee Optical Co., 348 U.S. 483, 486 (1955).

Although the extent of their medical training differs, ophthalmologists and optometrists perform the same function in regard to prescribing and dispensing glasses, and are both referred to in Subpart *C* as "eye doctors."

[32]*See* 45 WASH. L. REV. 838, 839-40 & n.7 (1970).

[33]*See* 16 C.F.R. § 192.7 (1974).

[34]*E.g.*, Mast v. State Bd. of Optometery, 139 Cal. App. 2d 78, 293 P.2d 148 (Dist. Ct. App. 1956). *See also* Blumenthal v. Board of Medical Examiners, 57 Cal. 2d 228, 368 P.2d 101, 18 Cal. Rptr. 501 (1962); Summers v. Board of Examiners in Optometery, 487 P.2d 706 (Okla. 1971).

[35]Letter from United States Department of Justice to a group of eye doctors, Sept. 10, 1951, in 16 C.F.R. § 192, app. (1974).

than repackage the drugs under a trade name and sell them to retailers.[36] Such firms are able to exist because of state antisubstitution statutes which require that prescribed brand names must be dispensed.[37]

Several physicians have found it profitable to obtain interests in repackaging companies. A physician can increase both the company's profit and the return of his investment by prescribing the company's brand-name drugs. An investigation by the Senate Subcommittee on Antitrust and Monopoly in 1964 disclosed that approximately 100 drug repackaging companies had sold financial interests to at least 5,000 physicians.[38] Despite assurance by the AMA that these doctors would rid themselves of these interests, the doctors have continued to hold stock or other financial interests in these companies.[39] Additionally, it is impossible to determine how many physicians concealed such interests by placing ownership in the names of members of their family.

There are other reasons for the undesirability of physician ownership of drug repackaging companies. Competitors of the doctor-owned company are unable to compete where the doctor-merchant is prescribing his own company's products. Also, the products of repackaging companies cost the consumer more than equivalent generic drugs. Doctors who own interests in repackaging companies tend to prescribe their company's drug when it is not therapeutically indicated or when some other drug is needed. They also tend to prescribe a larger quantity per prescription when they designate their company's drugs.[40] Of course, not every doctor financially connected with a repackaging company engages in these abuses.

E. Other Conflicts of Interest

Some physicians have financial interests in hospitals, medical labo-

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[36]Statement of Jesse L. Steinfeld, M.D., Surgeon General, USPHS, *1970 Hearings* 17.

[37]*See* the discussion of antisubstitution laws Part V(*D*) *infra*.

A generic name is an established name used to designate a particular drug formula or product in the *National Formulary* or *United States Pharmacopeia*. Many different companies manufacture drugs designated by the same generic name. A trade name is a registered name which one drug company has attached to its drug product. For example, in 1971 a particular steroid bore the generic name prednisone. Many companies marketed this drug under its generic name. Other companies offered the identical drug under a trade name. Prednisone was marketed by Merck Sharp & Dohme under the trade name Deltra, by Upjohn under the name Deltasone, and by Schering under the name Meticorten. If a doctor prescribed Deltasone, the pharmacist had to dispense Upjohn's product. AMERICAN PHARMACEUTICAL ASS'N, A WHITE PAPER ON THE PHARMACIST'S ROLE IN PRODUCT SELECTION 5-6 (1971).

[38]Statement of Senator Hart, *1964 Hearings* 2.

[39]Statement of Senator Moss, *1970 Hearings* 2.

[40]Hammel & Myers, *supra* note 4, at 413-14. M. Myers, Prescribing Habits of Physicians Who Own Pharmaceutical Companies, 1966 (unpublished thesis at the Univ. of Wis. in the Univ. of Miss. Pharmacy School Library).

ratories, and nursing homes. This interest tempts even ethical doctors who would not consciously consider admitting a patient to a hospital for their financial gain. These potential conflicts could destroy the public's confidence in the medical profession. An appearance of impropriety also is present when a doctor holds an interest in a nursing home. Further problems are extant in situations where a doctor owns a laboratory facility. In each of these situations, the doctor-merchant must choose between his patients' welfare and his financial well-being every time he sees a patient.[41]

Robert B. Throckmorton, General Counsel for the AMA, has explained that it is important to recognize the difference between the mere opportunity to exploit and actual exploitation. By its nature, the practice of medicine confronts practitioners with many potential conflicts of interest. Physicians must be trusted to refrain from converting these potential situations into actual exploitation of their patients. This trust is justified. The overwhelming majority of physicians are highly ethical professionals who take their duty seriously and act only in the best interest of their patients.[42] When, however, any potential conflict of interest becomes an actual conflict in which a number of the members of the profession are involved, this trust is violated, and measures must be taken to ensure that physicians do not take advantage of their position relative to their patients.

II. Medical Ethics

Prior to 1955 there was very little interest in legislating against doctor-merchants. This was the result of the AMA's strong policy declaration concerning the activities in which a physician might ethically engage: "An ethical physician does not engage in barter or trade in the appliances, devices, or remedies prescribed for patients, but limits the source of his professional income to professional services rendered the patient."[43] In 1955 and 1956 the ethic was relaxed, apparently to reflect the AMA's belief that situations exist where a patient's needs will be best served if he receives drugs from his doctor.[44] The Principles were again shortened and compiled in 1957. The provisions pertinent to doctor-merchants were grouped under section 7, the current ethic, which reads:

> In the practice of medicine a physician should limit the source of

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[41]*See* Statement of Dr. Robert L. Brent, Director of the Stein Research Center, *1970 Hearings* 103-12.

[42]Statement of Robert B. Throckmorton, *1964 Hearings* 220-22.

[43]Statement of Senator Moss, *1970 Hearings* 2.

[44]Letter from Edwin J. Holman, Director, AMA Department of Medical Ethics, to Dr. Jesse L. Steinfeld, Surgeon General, July 10, 1970, in *1970 Hearings* 18-19.

> his professional income to medical services actually rendered by him, or under his supervision, to his patients. His fee should be commensurate with the services rendered and the patient's ability to pay. He should neither pay nor receive a commission for referral of patients. Drugs, remedies or appliances may be dispensed or supplied by the physician provided it is in the best interests of the patient.[45]

The AMA Judicial Council's interpretation of section 7[46] allows a physician to own a pharmacy as long as he does not exploit his patients.[47] The council's definition of exploitation includes: Prescribing in a code that can be understood only by one pharmacist; maintaining a direct telephone line to a pharmacy; using prescription blanks imprinted with the name of a pharmacy; and otherwise depriving a patient of the freedom to have a prescription filled at the pharmacy of his choice.[48] This language is a departure from an earlier council ruling that physicians could not own a financial interest in, or lease on a percentage-of-income basis[49] to, any pharmacy in their area of medical practice.

Section 7 has been interpreted to allow a physician to dispense drugs if, in his sound discretion, he considers that it is "necessary or desirable" in the situation of a particular patient.[50] Local medical societies should have to learn the facts of a doctor's dispensing practices to prevent abuses of discretion.[51] Such abuses occur when a doctor dispenses for his own convenience or as a means of supplementing his professional income.[52] The Principles do not condone situations where the physician is in competition with local pharmacies.[53] The AMA urges physicians not to regularly dispense drugs "whenever the drug needs of patients can be met adequately by local ethical pharmacies."[54]

The 1954 position of the AMA in regard to ophthalmologists was that they could not ethically sell eyeglasses unless the patient could not

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[45]AMA PRINCIPLES OF MEDICAL ETHICS § 7 (1958).

[46]Professional ethics are moral guidelines created by members of a profession to govern their own professional conduct. It is submitted that the content of a profession's ethical code is the responsibility and concern only of the members of that particular profession. A person not a member of a profession may not properly urge changes in the profession's ethics. For this reason, no comment on or criticism of the *Principles of Medical Ethics* will be presented.

[47]OPINIONS AND REPORTS OF THE JUDICIAL COUNCIL ON AMA PRINCIPLES OF MEDICAL ETHICS § 7, ¶ 47. [hereinafter cited as JUDICIAL COUNCIL].

[48]*Id.* ¶¶ 49-52.

[49]AMERICAN MEDICAL ASS'N, DIGEST OF OFFICIAL ACTIONS 1846-1958, at 273 (1959).

[50]JUDICIAL COUNCIL ¶ 47.

[51]*Id.*

[52]*Id.*

[53]Bornemeir, *M.D.'s Provide Medical Service and You Offer Pharmaceutical Service*, 37 PHARMACY TIMES, May 1971, 30.

[54]JUDICIAL COUNCIL ¶ 48.

otherwise have obtained glasses without suffering hardship or inconvenience.[55] In any case the ophthalmologist could not obtain a profit from the sale of glasses.[56] The judicial council's present position is that "it is not improper for a physician to own an optical dispensing shop provided there is no exploitation of the patient."[57]

The judicial council interprets section 7 to make it unethical for a physician to hold a financial interest in a drug repackaging company[58] or a pharmaceutical company which, through stock ownership, he can or does control while he is actively engaged in the practice of medicine.[59] The AMA has taken a strong stand against such ownership because they believe it is neither commensurate with the best interests of the public nor the medical profession.[60]

It is unethical for a physician to accept a rebate from a pharmacy or drug company.[61] Although it would be logical to characterize the profit from drugs dispensed to patients from a pharmacy in which a doctor has an interest as a rebate, the judicial council, as indicated above, considers it ethical for a physician to own a pharmacy.

Violation of the Principles of Medical Ethics subjects a doctor to discipline by his professional colleagues,[62] including possible expulsion from his local medical society.[63] Expulsion may result in a higher rate for professional liability insurance or a denial of insurance, refusal of hospital staff privileges, and ostracization by his colleagues.[64] The consequences are no doubt sufficiently serious to prevent the great majority of physicians from engaging in any conduct which might approach a violation of the ethical code. Most physicians, in fact, regard these ethics as a moral law rather than a penal code that compels compliance by threat of loss of professional privileges.[65] It has been suggested, how-

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[55]AMERICAN MEDICAL ASS'N, *supra* note 49, at 275.

[56]*Id.*

[57]JUDICIAL COUNCIL ¶ 54.

[58]A drug repackaging company is a "drug company which markets under its own label or trade names drug products manufactured by others with the objective that physicians having a financial interest in the drug company will prescribe its drugs to the patient." *Id.* 56. There would seem to be little justification for the existence of such an operation no matter who owns the company's stock. A company whose sole business is purchasing generic drugs and placing a trade name on them so that they may be prescribed by trade name does little more than increase the already excessive cost of prescription drugs.

[59]*Id.* ¶ 47.

[60]*Id.*

[61]Letter from Edwin L. Holman, Director, AMA Department of Medical Ethics, to Dr. Jesse L. Steinfeld, Surgeon General, July 10, 1970, at *1970 Hearings* 18-19.

[62]Statement of Robert B. Throckmorton, AMA General Counsel, *1964 Hearings* 221.

[63]M. Myers, *supra* note 40, at 17.

[64]*Id.* 17-18.

[65]Statement of Robert B. Throckmorton, AMA General Counsel, *1964 Hearings* 221.

ever, that the hardcore doctor-merchants (those who find the profits produced by their professional conflicts-of-interest extremely attractive) would be more willing to lose their professional society membership than their pharmacy, repackaging company, or dispensing business.[66]

III. Attempts at Federal Legislation

In 1964 the Senate authorized the Committee on the Judiciary to conduct an investigation of the federal antitrust and monopoly laws to determine if existing laws were in need of clarification or improvement or if there was a need for additional legislation.[67] This resolution brought before the Subcommittee on Antitrust and Monopoly the matter of physician ownership of pharmacies and drug companies.[68] Senator Hart, the subcommittee chairman, 10 years ago began this controversy which "keeps boiling up."[69]

The conclusions drawn from the record of this hearing were: (1) Physician ownership of pharmacies and repackaging companies and doctor dispensing are relatively prevalent; (2) doctor-merchants use their ownership and dispensing privileges to increase their profits; (3) when a doctor-merchant stands to profit from his operations, his prices tend to be higher; and (4) the competitive position of independent businessmen is adversely affected by doctor-merchants.[70] These determinations prompted Senator Hart to conclude that the doctor-merchant was harming both consumers and competition to a degree that made necessary "legislation which would prohibit physicians from profiting from the sale of any product [prescribed by them]."[71] Senator Hart introduced such legislation in 1965[72] and proposed that the act would both prevent the doctor-merchant from continuing his anticompetitive practices and protect the legitimate interests of the medical profession.[73]

The bill, offered as an addition to the existing antitrust laws, was intended to make physician ownership of pharmacies and repackaging companies unlawful by prohibiting physicians from receiving profits, rebates, or other valuable considerations from the supplying of prescrip-

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[66]Statement of William S. Apple, Executive Director, APhA, *1967 Hearings* 165. Pharmacists in Iowa were prevented by their professional ethics from practicing in physician-owned pharmacies. A number of these pharmacists thought their interests were better served if they remained in the doctors' pharmacies despite loss of membership in professional organizations. *Id.* Pharmacy ethics are discussed in Part V(C)(2) *infra*.

[67]S. Res. 262, 88th Cong., 2d Sess., 110 Cong. Rec. 2686 (1964).

[68]*1964 Hearings*.

[69]Garcha, *supra* note 19.

[70]111 Cong. Rec. 25239 (1965) (remarks of Senator Hart).

[71]*Id.* at 25238.

[72]S. 2568, 89th Cong., 1st Sess. (1965).

[73]*See* 111 Cong. Rec. 25239 (1965).

tion medical products.[74] The act, however, permitted a doctor to supply his patient with a drug or device in an emergency and to administer unit doses of drugs to patients.[75] Violation of the act was to be a misdemeanor punished by a fine up to $5,000 or up to 1 year's imprisonment.[76]

The law was to be equally applicable to an ophthalmologist who owns an optical dispensary or dispenses eyeglasses from his office.[77] It did not, however, purport to prohibit eyeglass-dispensing by optometrists, who are not licensed to practice medicine.[78] It appears that the same potential for patient exploitation and damage to independent opticians exists when an optometrist dispenses or owns an optical dispensary as when an ophthalmologist does so.

The act met with no success in the Senate, and in 1967 Senator Hart introduced a rewritten and strengthened Medical Restraint of Trade Act.[79] This act was more specific than its earlier counterpart. It forbade a medical practitioner to sell drugs or devices, including eyeglasses.[80] It made it unlawful for a practitioner to own a pharmacy or a retail or wholesale optical dispensary or to hold a leasehold interest in one leased at an unreasonable rental or on a percentage-of-income basis.[81] The act dealt with drug repackaging companies by declaring unlawful arrangements by which a practitioner would receive a reward for having prescribed a particular company's drugs.[82] The criminal penalties of the 1965 act were omitted, but any person whose business was injured by a violation of the act was given the right to sue in district court and recover treble damages, the costs of court, and a reasonable attorney's fee.[83]

Senate hearings were held in 1967, and two more volumes were added to the great amount of material already in existence.[84] Despite the voluminous transcripts detailing the harm caused to consumers and competition by the doctor-merchant, the bill was lost in the Senate committees.

Senator Hart again revived and revised his legislation in 1969.[85] As

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[74]S. 2568 bears a resemblance to the optical products rules of 16 C.F.R. § 192.7 (1974), discussed Part IV *infra*.

[75]S. 2568, 89th Cong., 1st Sess. § 4(a)(2) (1965).

[76]*Id.* § 4(b).

[77]111 CONG. REC. 25238-39 (1965) (remarks of Senator Hart).

[78]*See* S. 2568, 89th Cong., 1st Sess. §§ 3(b), 4(a) (1965).

[79]S.260, 90th Cong., 1st Sess. (1967).

[80]*Id.* §§ 3(b)-(c), 4.

[81]*Id.* § 4.

[82]*Id.* § 6; *cf.* 113 CONG. REC. 308 (1967) (remarks of Senator Hart).

[83]S. 260, 90th Cong., 1st Sess. § 8 (1967). Unlike its predecessor, S. 260 may have been intended to apply to optometrists. *See id.* § 3(a).

[84]*1967 Hearings.*

[85]S. 1575, 91st Cong., 1st Sess. (1969).

before, both the ownership of a drug company by a physician for other than investment purposes and the payment of rebates in connection with prescription of a company's products were made unlawful.[86] The new act made a physician's acquisition of an interest in a company which has been offered to the public prima facie evidence that the acquisition was for investment purposes.[87] Doctor dispensing was also prohibited by this act.[88] An exception, however, would allow a medical practitioner to dispense on an occasional basis.[89] The 1969 bill would only prohibit a physician from owning or holding a leasehold interest in a pharmacy geographically located within a 10-mile radius of his professional office.[90]

The bill is the product of years of study. It has been reworded, revised, and improved several times; yet, there are two major omissions. The bill does not regulate physician ownership of laboratory services, hospitals or nursing homes,[91] and it specifically exempts ophthalmologists and optometrists.[92] Any legislation aimed at eliminating conflicts of interest in the medical profession should go further than the regulation of the dispensing of drugs and devices. The bill should cover all areas of the health-care industry where a medical practitioner's financial interest burdens him with having to choose between the patient's welfare and his own income.[93]

The bill was referred to the Consumer Subcommittee of the Committee of Commerce and seemed to gain impetus. Congressman Corman introduced it in the House of Representatives[94] and Virginia H. Knauer, Special Assistant to the President for Consumer Affairs,[95] Deputy Attorney General Richard Kleindienst,[96] FTC Chairman Caspar

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[86]*Id.* § 4.

[87]*Id.* § 4(b).

[88]*Id.* § 5.

[89]*Id.*

[90]*Id.* § 3(e).

[91]Statement of Dr. Robert L. Brent, *1970 Hearings* 104-05.

[92]S. 1575, 91st Cong., 1st Sess. § 3(a) (1969). Homeopathic physicians, dentists, and veterinarians are also exempted. *Id.* Senator Moss, Chairman of the Consumer Subcommitte, when questioned about the reasons for exemption of ophthalmologists and optometrists, replied: "It beats me. I don't know." 1970 *Hearings* 111.

[93]*Id.* 104. A thorough bill might also cover pharmacists. It is submitted that a conflict of interest arises when a prescription for a generic drug gives a pharmacist the right to choose among a number of manufacturers of the generic drug and the pharmacist owns an interest in a company marketing the drug under a trade name. *See* 119 CONG. REC. S10820 (daily ed. June 11, 1973) (remarks of Senator Nelson) (generic vs. trade name drugs).

[94]H.R. 9521, 91st Cong., 1st Sess. (1969).

[95]Letter from Virginia H. Knauer to Senator Magnuson, July 29, 1970, in *1970 Hearings*, 11-12.

[96]Letter from Richard G. Kliendienst to Senator Magnuson, Aug. 4, 1970, in *1970 Hearings* 12.

Weinberger,[97] and Surgeon General Jesse L. Steinfeld[98] endorsed the objectives of the bill. Despite this support, the bill became enmeshed in the Committee on Commerce.

The Regulation of Trade in Drugs Act[99] was reintroduced in the House by Congressman Bill Burlinson in the second session of the Ninety-first Congress.[100] Senator Hart made his fourth attempt to push through legislation against the doctor-merchant in 1971.[101] Congressman Corman again tried to get the House moving on the Regulation of Trade in Drugs Act in 1972[102] and 1973.[103] No further attempts at federal legislation have been found.

No information is available on whether there will be further efforts toward federal legislation. Even less certain is the chance of such legislation ever becoming law. A much stronger lobbying effort on the part of pharmacists' organizations and consumers' groups is needed before any act will have a realistic chance of passage.[104]

IV. ANTITRUST CONSIDERATIONS

When Senator Hart introduced his bill,[105] Senators Dirksen and Hruska argued that state legislatures and professional associations are the proper bodies to deal with the doctor-merchants.[106] They further suggested that the Justice Department and the Federal Trade Commission (FTC) could handle errant practitioners under the authority of existing antitrust legislation.[107] The Senators' view did not find support with Paul Rand Dixon of the FTC, who declared that the practices of the doctor-merchant "are intimately connected with and embrace the physician's practice of his profession. Regulation of medical practice

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[97]Letter from Caspar Weinberger to Senator Magnuson, Aug. 7, 1970, in *1970 Hearings* 13.

[98]Statement of Dr. Jesse Steinfeld, Surgeon General, USPHS, *1970 Hearings* 18. Among other things, Dr. Steinfeld suggested that section 3(e) of S. 1575 should be revised because the present wording would make it unlawful under section 6 for a physician to own a grocery store within 10 miles of his office if over-the-counter drugs were sold there. *Id.* 17.

[99]H.R. 19488, 91st Cong., 2d Sess. (1970).

[100]*See* 116 CONG. REC. 34254 (1970) (remarks of Congressman Burlinson).

[101]S. 2749, 92d Cong., 1st Sess. (1971); *see* 117 CONG. REC. 37630-31 (1971) (remarks of Senator Hart).

[102]H.R. 16274, 92d Cong., 2d Sess. (1972).

[103]H.R. 7629, 93d Cong., 1st Sess. (1973).

[104]Garcha, *supra* note 19, at 20.

[105]S.2568, 89th Cong., 1st Sess. (1965); *see* discussion Part III *supra*.

[106]111 CONG. REC. 25241 (1965) (views of Senators Dirksen and Hruska).

[107]*Id.* The antitrust statutes referred to are: Sherman Antitrust Act, 26 Stat. 209 (1890), 15 U.S.C. § 1 (1970); Clayton Act, 15 U.S.C. § 15 (1970); Federal Trade Commission Act, 38 Stat. 719 (1914), 15 U.S.C. § 45 (1970). State antitrust legislation would be ineffective in most cases. Hammel & Myers, *supra* note 4, at 421.

historically and inherently has been by the states."[108] The premise underlying this examination of whether a doctor-merchant can be dealt with under Section 1 of the Sherman Act[109] or Section 5 of the Federal Trade Commission Act[110] is that by controlling where patients have their prescriptions filled or what brand of drug or device they receive, the doctor undermines the ability of the independent pharmacist, optician, and pharmaceutical company to compete effectively in the marketplace.[111]

The United States Department of Justice employed Section 1 of the Sherman Act to obtain consent decrees[112] against a large number of ophthalmologists who were receiving rebates for directing their patients to large optical products corporations.[113]

Federal action against the optical industry inspired the FTC to issue rules under Section 6(g) of the Federal Trade Commission Act[114] governing the practices of the industry.[115] Trade practice rules represent

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[108]Letter from Paul Rand Dixon to Senator Hart, July 8, 1965, *1967 Hearings* 24.

[109]26 Stat. 209 (1890), 15 U.S.C. § 1 (1970).

[110]38 Stat. 719 (1914), 15 U.S.C. § 45 (1970).

> Any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor in any district court of the United States . . . without respect to the amount in controversy, and shall recover threefold the damages by him sustained . . . .

Clayton Act, 15 U.S.C. § 15 (1970). Despite the fact that the Clayton Act does away with the requirements that there must be injury to the public in an amount in controversy exceeding $10,000, it would probably not afford the injured competitor much of a remedy. The person injured by a doctor-merchant would have difficulty establishing with certainty the amount he has been damaged. Hammel & Myers, *supra* note 4, at 423-24 n.48.

[111]Note, *Is the North Dakota Statutory Requirement that Pharmacies Be Owned by Registered Pharmacists A Valid Exercise of Police Power?*, 39 N.D.L. Rev. 447, 456 (1963); Statement of Senator Hart, *1964 Hearings* 1-2.

[112]After a proceeding under the antitrust laws is instituted, the government and the defendent may negotiate a contract-type agreement setting forth the conditions under which an antitrust proceeding will be terminated. These decrees or consent judgments are judicial or quasi-judicial acts entered before the trial begins. They contain no admissions of fact or law. Timberg, *A Primer on Antitrust Consent Judgments and FTC Consent Orders*, 39 Brooklyn L. Rev. 567 (1973).

[113]The Department of Justice drew three conclusions from the "Optical Rebating Cases":

> (1) Doctors are enjoined from directly or indirectly accepting from any optical dispenser any type of payment for referral of a patient.
>
> (2) A doctor or group of doctors practicing together may dispense to their own patients through their offices.
>
> (3) Doctors may not acquire an interest in an optical dispensary and direct their patients there to have their prescriptions filled.

Letters from the Department of Justice to a group of eye doctors, May 28, 1951, in 16 C.F.R. § 192, app. (1974); *see, e.g.*, United States v. American Optical Co., 97 F. Supp. 66 (N.D. Ill. 1951).

[114] 15 U.S.C. § 46(g) (1970).

[115]*Physician Ownership in Pharmacies* 65.

the FTC's views on the type of practices proscribed by the antitrust laws.[116] The FTC offers the rules to industry as guidelines for compliance with the antitrust laws[117] and makes it clear that noncompliance will result in proceedings alleging unfair methods of competition or unfair or deceptive acts or practices in commerce.[118]

The trade practice rules for the optical products industry[119] delineate certain business conduct of ophthalmologists, oculists, physicians, optometrists, and optical dispensers that will be deemed unfair trade practices. The rules prohibit optical dispensers from directly or indirectly making to any refractionist "any payment arising out of or connected with [the dispenser's] sale or dispensing of eyeglasses or contact lenses to a patient of such [refractionist] . . . ."[120] The FTC makes it clear, however, that a refractionist may dispense through his own offices,[121] unless "such practice effects, or has a reasonable probability of effecting, substantial injury to competition, or creates or tends to create a monopoly . . . ."[122]

Since the sale of prescription drugs is closely akin to the sale of eyeglasses, the FTC should be able to promulgate rules governing the physician-pharmacist relation.[123] The FTC could declare it to be an unfair trade practice for a prescription drug company or pharmacist to make any type of payment to a physician in consideration for the physician's prescribing the company's brand name or referring a patient to the pharmacy. The effect of such a rule would be to prohibit physicians in individual or group practice from owning a drug manufacturing or repackaging company unless the physician does not prescribe that company's brand name. The rule might also prohibit a physician from owning a pharmacy to which his patients were referred. The compensation the physician would receive for his ownership would be considered a "payment" within the meaning of the rule.[124] The physician dispensing drugs through his own offices for a profit, however, could be held to have participated in an unfair trade practice only if he tied in his professional

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[116]Comment, *Substantive Rule-Making in the Federal Trade Commission: The Validity of Trade Regulation Rules*, 59 IOWA L. REV. 629, 630 (1974).

[117]16 C.F.R. § 17.1 (1974).

[118]16 C.F.R. §§ 17.1, 17.3 (1974). The language employed in the trade practice rules suggests that violators will be dealt with under Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45 (1970).

[119]16 C.F.R. §§ 192 *et seq.* (1974).

[120]*Id.* § 192.7(b).

[121]*Id.* § 192.7(b) n.1.

[122]*Id.* § 192.7(c).

[123]*Physician Ownership in Pharmacies* 66.

[124]*See* 16 C.F.R. § 192.7(b) & n.2(a) (1974). Presumably a physician could own a drug manufactory, repackaging company, or pharmacy so long as he received no profits from drugs dispensed to *his* patients.

services with his dispensing business in such a way as to injure competition or create a monopoly in the community.[125]

A difficulty inherent in the creation of trade practice rules for the prescription drug industry is that the rules may represent only an administrative interpretation of the antitrust laws.[126] The FTC would have to find that the doctor-merchant is subject to existing antitrust legislation before rules could be created. The pressing question, then, is whether the doctor-merchant is vulnerable to antitrust prosecution.

Both the Sherman and Federal Trade Commission Acts are addressed to the concept of "trade" or "commerce."[127] Although no statute gives support to the theory, courts have long toyed with the idea that "learned professions" are exempt from antitrust laws.[128] This debate is, however, "utterly irrelevant."[129] Prescription drugs, manufactured outside a state and shipped in interstate commerce to a wholesale drug firm and eventually to a pharmacy, are goods in interstate commerce.[130] Even the acts of transferring drugs to another container and dispensing them

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[125]*See id.* § 192.7(c).

[126]*Id.* §§ 17.1, 17.3.

[127]15 U.S.C. §§ 1, 45 (1970).

[128]Note, *Antitrust Law: An Application of the Sherman Act to the Professions*, 25 U. FLA. L. REV. 740 (1973). Language like the following may be responsible for the notion of professional immunity:

> [T]here are ethical considerations where the historic and direct relationship between patient and physician is involved which are quite different than the usual considerations prevailing in ordinary commercial matters. This Court has recognized that forms of competition usual in the business world may be demoralizing to the ethical standards of a profession.

United States v. Oregon State Medical Soc'y, 343 U.S. 326, 336 (1952) (citations omitted); *see* Goldfarb v. Virginia State Bar, 335 F. Supp. 491 (E.D. Va. 1973) (professional services held a "trade" subject to the Sherman Act). *But see* Lincoln Rochester Trust Co. v. Freeman, 34 N.Y.2d 1, 311 N.E.2d 480, 355 N.Y.S.2d 336 (1974) (legal profession not "trade" within meaning of the state act). *See also* United States v. Oregon State Medical Soc'y, 343 U.S. 326, 339 (1952); AMA v. United States, 317 U.S. 519 (1943); Marjorie Webster Junior College v. Middle State Ass'n of Colleges & Secondary Schools, Inc., 302 F. Supp. 459 (D.D.C. 1969) (implied the absence of immunity to Section 3 of Sherman Act applicable to D.C.).

For discussions of professional immunity, see Comment, *Minimum Fee Schedules v. Antitrust: The Goldfarb Affair*, 45 MISS. L.J. 162 (1974); Comment, *Private Physicians Unions: Federal Antitrust and Labor Law Implications*, 20 U.C.L.A.L. REV. 983 (1973); Note, *The Applicability of the Sherman Act to Legal Practice and Other "Noncommercial" Activities*, 82 YALE L.J. 313 (1972).

[129]*See* Northern Cal. Pharmaceutical Ass'n v. United States, 306 F.2d 379, 383-84 (9th Cir.), *cert. denied*, 371 U.S. 862 (1962).

[130]United States v. Utah Pharmaceutical Ass'n, 201 F. Supp. 29, 33 (D. Utah), *appeal dismissed*, 306 F.2d 493 (10th Cir.), *dismissal aff'd*, 371 U.S. 24 (1962). Under this rule, even the physician-owned repackaging company that purchases goods in interstate commerce, repackages them under its own brand name, and sells its products to physicians and pharmacies wholly within one state would nevertheless be dealing with goods in interstate commerce. *But see* Hammel & Myers, *supra* note 4, at 421.

to patients could be considered interstate activities.[131] Thus the dispensing, or retail function of the practice of pharmacy as opposed to the function of rendering professional services, is not exempt from the antitrust laws.[132] The doctor-merchant does not perform a "professional activity" when he dispenses drugs through his office or through ownership of a pharmacy or pharmaceutical company. Physicians, as "[m]embers of a learned profession [are no] more at liberty to restrain interstate trade in goods than any other class of persons."[133] By finding that the acts of doctor-merchants are interstate commerce, the initial bar to application of the antitrust laws is overcome.

Section 1 of the Sherman Act declares: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, . . . is . . . illegal . . . ."[134] By owning a repackaging company and prescribing its brand-name products, the physician assures that his patient will not receive the drugs of his company's generic or brand-name competitors. By directing patients to their jointly-owned pharmacy, doctors in group practice can prevent independent pharmacies in the community from filling prescriptions for those doctors' patients. Even the rural doctor with an in-office dispensing concession can discourage the entry of a pharmacy into his area. By these and other methods the doctor-merchant can destroy competition and monopolize the sale of prescription drugs in interstate commerce.

As pointed out by the Supreme Court in *United States v. Topco Associates*,[135] every business practice that restrains interstate trade will not violate section 1.[136] With an "in commerce" transaction, as distinguished from an "affects commerce" transaction, the critical question is whether the restraint is a "per se" or a "rule of reason" violation.[137] The per se restraint is regarded as so inherently anticompetitive that it is illegal regardless of whether the amount of interstate commerce is substantial.[138] Classic per se violations are horizontal restraints, which are combinations or agreements between competitors at the same level, for example, retailers who divide up a market to lessen competition.[139]

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[131]Northern Cal. Pharmaceutical Ass'n v. United States, 306 F.2d 379, 386 (9th Cir.), *cert. denied*, 371 U.S. 862 (1962).

[132]American Pharmaceutical Ass'n v. United States, 344 F. Supp. 9, 12 (E.D. Mich.), *aff'd.*, 467 F.2d 1290 (6th Cir. 1972).

[133]United States v. Utah Pharmaceutical Ass'n, 201 F. Supp. 29, 33 (D. Utah), *appeal dismissed*, 306 F.2d 493 (10th Cir.), *dismissal aff'd*, 371 U.S. 24 (1962).

[134]15 U.S.C. § 1 (1970).

[135]405 U.S. 596 (1972).

[136]*Id.* at 600-07; *see* United States v. Bensinger Co., 430 F.2d 584, 588 (8th Cir. 1970); Hammel & Myers, *supra* note 4, at 421-23.

[137]United States v. Bensinger Co., 430 F.2d 584, 589 (8th Cir. 1970).

[138]*Id.* at 588-89.

[139]United States v. Topco Associates, 405 U.S. 596, 608 (1972).

Other per se violations include arrangements to fix prices, agreements to limit or control the amount of production, agreements not to compete, and exclusive dealing arrangements.[140] The majority of restraints, however, are tested by the rule of reason.[141] The determination of whether a restraint is unreasonable is made by considering:

> (a) the identity of the market affected by the restraint, (b) the percentage of the relevant market which is affected by the restraint, [and] (c) the relationship of the percentage of the relevant market which is affected by the restraint to the reasonableness of the restraint.[142]

The legality of the doctor-merchant's restraint would be tested under the rule of reason; his activities are not of the type necessary to invoke the per se rule. Under the reasonableness test, some degree of substantial interference with interstate commerce is required before a violation can be found.[143] Since only a small number of physicians engage in anticompetitive practices in relation to the whole medical profession, the restraints would not be unreasonable. This conclusion might differ where doctors in group practice control the prescription drug trade in a large area or where a substantial number of physicians who own an interest in a repackaging company write prescriptions for their company's brand-name to the exclusion of all competitors.

A final, troublesome requirement for the establishment of a Sherman Act violation is that there must be a contract, combination, or conspiracy to restrain interstate trade or commerce.[144] The sole practitioner dispensing through his office or through a pharmacy he owns cannot conspire to restrain trade. Two or more persons are necessary to constitute a conspiracy.[145] Under the dominant view, even a group of doctor-stockholders in a repackaging company or a group of doctors owning a pharmacy in a clinic would not constitute a contract, combination, or conspiracy; a corporation cannot combine with itself to violate the antitrust laws.[146] A similar analysis indicates that doctors in group practice could not conspire to restrain trade with the pharmacist employed in their clinic pharmacy. It has been suggested, however, that a combination or conspiracy may exist among the physician-owners of a

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[140]Worthen Bank & Trust Co. v. National BankAmericard Inc., 345 F. Supp. 1309, 1320 (E.D. Ark. 1972).

[141]United States v. Topco Associates, 405 U.S. 596, 607 (1972).

[142]Worthen Bank & Trust Co. v. National BankAmericard Inc., 345 F. Supp. 1309, 1320 (E.D. Ark. 1972).

[143]*See* United States v. Topco Associates, 405 U.S. 596, 606 (1972).

[144] 15 U.S.C. § 1 (1970).

[145]Kendall Elevator Co., Inc. v. LBC & W Associates Inc., 350 F. Supp. 75, 78 (D.S.C. 1972).

[146]*Id.*

drug repackaging company.[147] In such a case, the conspiracy or combination is found not in the act of owning the company but in prescribing the company's brand-name drugs for the purpose of inflating profits.[148]

It is unlikely that prosecution of the doctor-merchant would be possible under the Sherman Act,[149] even though such physicians do restrain trade in interstate commerce. The Sherman Act is aimed at practices posing a much greater threat to free enterprise than those of the doctor-merchant.

Section 5 of the Federal Trade Commission Act declares "[u]nfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce . . . unlawful."[150] The FTC is empowered to bring a proceeding against any person, partnership or corporation engaging in such unlawful practices, if to do so would be in the public interest.[151] The phrase "unfair or deceptive acts or practices" was added to section 5 by the 1938 Wheeler-Lea Amendment,[152] to make clear that the FTC is a champion of consumer welfare as well as a protector of competitors.[153] The Court gave force to this legislative intent by holding, in *FTC v. Sperry & Hutchinson Co.*,[154] that section 5 vests in the Commission the power to proceed against unfair methods of competition that violate neither the letter nor the spirit of the antitrust laws, and to "proscribe practices as unfair or deceptive in their effect upon consumers regardless of their nature or quality as competitive practices or their effect on competition."[155] This seems to be a further expansion of cases like *FTC v. Brown Shoe Co.*[156] where the Court stated that the Commission has "broad powers" to declare trade practices in conflict with the basic policies of the Sherman and Clayton Acts to be unfair.[157] Thus a practice not at odds with the theories of the other antitrust laws is not necessarily immune from prosecution under section 5.

Like the Sherman Act, the Federal Trade Commission Act covers only transactions in interstate commerce;[158] but unlike the Sherman Act, interstate activity need not be of a certain magnitude before the FTC can exercise its powers.[159] It is quite probable, however, that de-

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[147]Hammel & Myers, *supra* note 4, at 424-25.

[148]*Id.*

[149]*Id.*; *see* text accompanying note 143 *supra*.

[150]15 U.S.C. § 45(a)(1) (1970).

[151]*Id.* § 45(b); *see* FTC v. Raladam Co., 283 U.S. 643, 646-47 (1931).

[152]52 Stat. 111 (1938).

[153]FTC v. Sperry & Hutchinson Co., 405 U.S. 233, 244 (1972).

[154]405 U.S. 233 (1972).

[155]*Id.* at 239.

[156]384 U.S. 316 (1966).

[157]*Id.* at 320-21; *accord*, Luria Bros. & Co. v. FTC, 389 F.2d 847, 859-60 (3d Cir. 1968).

[158]Guziak v. FTC, 361 F.2d 700, 703 (8th Cir. 1966).

[159]*Id.*, *citing* FTC v. Raladam Co., 316 U.S. 149 (1942).

spite *Sperry & Hutchinson*, the incipient practice will not be interfered with unless it will have a strong adverse effect on competition or the consumer when in full bloom.[160]

The doctor-merchant secures a definite competitive advantage when he can direct his patients to buy drugs from him or his pharmacy. The same competitive advantage is present when the physician prescribes drugs merchandised by his repackaging company. These practices are probably within the FTC's notion of what is "unfair"[161] and are of the same type prohibited by the trade practice rules for the optical products industry.[162] They probably do not represent violations of section 5, however, because vis-a-vis the entire industry the injury is insignificant.[163]

Even if the doctor-merchant's practices were to be considered a substantial interference with interstate commerce, it is improbable that the government would take action.[164] The task of bringing an action against each individual physician violating the antitrust laws would keep an army of government lawyers occupied for years.[165] The antitrust laws are aimed at bigger game.

V. State Control

A. *General Ownership Statutes*

Until December 1973,[166] the constitutionality of every state legislative attempt to separate the doctor-merchant from his income-producing retail business was in doubt.[167] This doubt was occasioned by

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[160]*See* FTC v. Texaco, 393 U.S. 223, 225 (1968); *Physician Ownership in Pharmacies* 69.

[161]The FTC will look at certain factors to determine if a practice that does not violate the antitrust laws and is not deceptive is nevertheless unfair:

> (1) whether the practice, without necessarily having been previously considered unlawful, offends public policy as it has been established by statutes, the common law, or otherwise—whether . . . it is within at least the penumbra of some common-law, statutory or other established concept of unfairness;
>
> (2) whether it is immoral, unethical, oppressive, or unscrupulous;
>
> (3) whether it causes substantial injury to consumers (or competitors or other businessmen).

Statement of Basis and Purpose of Trade Regulation Rule, 29 Fed. Reg. 8355 (1964).

[162]*Physician Ownership in Pharmacies* 69. *See also* Hammel & Myers, *supra* note 4, at 427 (financial interest in trade name drugs prescribed).

[163]*Physician Ownership in Pharmacies* 69-70.

[164]*Id.*

[165]The number of doctors dispensing drugs has been estimated at anywhere between 10,500 to 16,500 in the years 1967 to 1970. Garcha, *supra* note 19, at 20. *See generally Physician Ownership in Pharmacies* 70.

[166]North Dakota State Bd. of Pharmacy v. Snyder's Drug Stores, Inc., 414 U.S. 156 (1973).

[167]*Physician Ownership in Pharmacies* 61 (an "open question").

Louis K. Liggett Co. v. Baldridge,[168] a 1928 decision of the United States Supreme Court. A Pennsylvania district attorney had threatened Liggett with prosecution for violation of the pharmacy ownership statute requiring that "every pharmacy or drug store . . . be owned only by a licensed pharmacist . . . ."[169] The corporation, whose shareholders were not all registered pharmacists, filed suit to enjoin enforcement of the act on the ground that it ran afoul of the due process and equal protection clauses of the 14th amendment.[170] After finding that Liggett Company's business was a property right entitled to protection against unconstitutional state legislation, the Supreme Court framed the issue: Whether the ownership statute had a "real and substantial relation" to promotion of public health or whether it was "a clear and arbitrary invasion of appellant's property rights guaranteed by the Constitution."[171] The Court analyzed the various statutes regulating the practice of medicine and pharmacy and concluded that they were such that a nonpharmacist owner could do nothing in relation to the compounding or dispensing of drugs that could endanger public health.[172] The absence of the requisite "real and substantial relation to public health" compelled the Court to hold the statute unconstitutional.[173]

Although the Supreme Court many times repudiated the logic behind *Liggett*,[174] the decision itself remained unchallenged until *North Dakota State Board of Pharmacy v. Snyder's Drug Stores, Inc.*[175]

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[168]278 U.S. 105 (1928).

[169]No. 491, § 1, [1927] Pa. Laws 1009.

[170]U.S. CONST. amend XIV. The statute's constitutionality had been upheld in the lower court on the ground that since the nonpharmacist, corporate owner would be concerned more with the price rather than the quality of prescription compounding and dispensing, the ownership statute addressed a possible evil bearing a "substantial relation" to the public interest. 278 U.S. at 110-11.

[171]278 U.S. at 111.

[172]*Id.* at 112-13.

[173]*Id.* at 113. The position of Mr. Justice Holmes, in dissent, was that:

> The Constitution does not make it a condition of preventive legislation that it should work a perfect cure. It is enough if the questioned act has a manifest tendency to cure or at least to make the evil less.

Id. at 115, *quoted with approval in* North Dakota State Bd. of Pharmacy v. Snyder's Drug Stores, Inc., 414 U.S. 156, 167 (1973). State courts held unconstitutional similar statutes on the authority of *Liggett* in State v. People's Drug Stores, Inc., 36 Del. 120, 172 A. 257 (1934); Pratter v. Lascoff, 261 N.Y. 509, 185 N.E. 716, *cert. denied*, 289 U.S. 754 (1933).

[174]*E.g.*, Ferguson v. Skrupa, 372 U.S. 726 (1963) (statute prohibiting persons other than lawyers from engaging in the business of debt adjusting held constitutional); Williamson v. Lee Optical Co., 348 U.S. 483 (1955) (statute prohibiting opticians from fitting or duplicating lenses without a prescription held constitutional); Daniel v. Family Sec. Life Ins. Co., 336 U.S. 220 (1949) (statute prohibiting life insurance companies from operating undertaking businesses held constitutional); Lincoln Federal Labor Union v. Northwestern Iron & Metal Co., 335 U.S. 525 (1949) (statute stating that no person shall be denied employment because he is or is not a union member held constitutional).

[175]414 U.S. 156 (1973).

Snyder's involved a statute very similar to the one in *Liggett*, but only requiring a majority ownership by pharmacists.[176] Snyder's Drug Stores, Inc. was denied a pharmacy permit because less than a majority of the corporation's stockholders were registered pharmacists. The North Dakota Supreme Court felt bound by the *Liggett* substantial-relation criterion and held that the statute violated the due process clause.[177] The pharmacy board appealed to the Supreme Court. A unanimous Court, in an opinion by Mr. Justice Douglas, overruled *Liggett*[178] and upheld the constitutionality of the statute.[179] The Court reexpressed the view that when a statute is attacked on due process grounds, the state legislature will be given wide discretion to define and legislate against practices found to be injurious to public health, safety, welfare, or morals, without having its statutes subjected to the strict "real and substantial relation" test.[180] *Snyder's* was reversed, remanded, and heard again by the North Dakota Supreme Court;[181] Snyder's attacked the ownership statute as contrary to portions of the North Dakota Constitution,[182] and the equal protection and commerce clauses of the United States Constitution. Upholding the statute against both state and federal constitutional attacks, the court reversed its earlier position and put an end to doubts about the statute's constitutionality.[183]

The Court's unequivocal overruling of *Liggett* suggests that a statute requiring total pharmacist ownership will be upheld.[184] The implications of this conclusion are far-reaching; 60.1 percent of the 1972 total national volume of drug sales has been attributed to corporate chain drugstores.[185] Should a large number of states enact restrictive ownership legislation, the grip of the chain drugstore on the pharmacy profession would be loosened. The result would be a pharmacy profession able to exercise its professional judgement in determining public interest without the coercive influence of nonpharmacist owners concerned more with profit margins than professional responsibility.[186]

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[176]N.D. CENT. CODE § 43-15-35(5) (Supp. 1973), *analyzed in* Note, *supra* note 111.

[177]Snyder's Drug Stores, Inc. v. North Dakota State Bd. of Pharmacy, 202 N.W.2d 140 (N.D. 1972).

[178]North Dakota State Bd. of Pharmacy v. Snyder's Drug Stores, Inc., 414 U.S. 156, 167 (1973).

[179]*Id.*

[180]*Id.* at 164-67.

[181]Snyder's Drug Stores, Inc. v. North Dakota State Bd. of Pharmacy, 219 N.W.2d 140 (N.D. 1974).

[182]N.D. CONST. art. 1, §§ 11, 13, 20.

[183]Snyder's Drug Stores, Inc. v. North Dakota State Bd. of Pharmacy, 219 N.W.2d 140 (N.D. 1974).

[184]*See* 414 U.S. at 158.

[185]Brief for the APhA and NARD as Amicus Curiae at 11, North Dakota State Bd. of Pharmacy v. Snyder's Drug Stores, Inc., 414 U.S. 156 (1973). Corporate chain stores had a national sales volume of $1.5 billion in 1972. *Id.*

[186]*Id.* at 12-13.

The Supreme Court did not discuss the North Dakota Legislature's reasons for enacting the statute, and physician ownership of pharmacies was not considered.[187] The issue was raised in the second North Dakota case where Snyder's contended that the statute was aimed at the prohibition of physician ownership and that the statute was not necessary for that purpose.[188] The court refused to acknowledge that physician ownership was the evil at which the statute was directed[189] but did decide that prevention of physician ownership would be one of several justifications for a restrictive statute.[190] Since the Supreme Court will not look deeply into a state's motivations for enacting corrective legislation, a statute directed specifically at physicians would be at least as proper as one directed at nonpharmacist owners. There is now little doubt that the due process clause will permit a state to proscribe physician ownership of pharmacies.

Michigan also has a statute restricting the ownership of pharmacies by nonpharmacists.[191] It requires that the sole proprietor of a pharmacy be a registered pharmacist but allows a partnership or corporation to own a pharmacy if registered pharmacists hold 25 percent of the stock. The Michigan statute has never been challenged on constitutional grounds; however, it could be upheld on the authority of *Snyder's*.

General restrictive ownership statutes like the Michigan and North Dakota legislation serve a dual purpose; they threaten the corporate chainstore pharmacy and they tend to alleviate the doctor-merchant problem. Under neither statute is a physician permitted to own a pharmacy by himself. Both statutes, however, allow physicians to own interests in pharmacies as long as a majority of the owners in North Dakota and 25 percent of the owners in Michigan are registered pharmacists. These statutes do not completely control the doctor-merchant. He is still able to exploit his patients by charging higher prices, overprescrib-

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[187]The APhA and the NARD did suggest that physician ownership was an evil that would justify a restrictive ownership statute. *Id.* at 15.

[188]Snyder's Drug Stores, Inc. v. North Dakota State Bd. of Pharmacy, 219 N.W.2d 140, 146 (N.D. 1974).

[189]*Id.* at 147.

[190]*Id.* at 151.

[191]MICH. COMP. LAWS ANN. § 338.481(1) (1967); *see* Superx Drugs Corp. v. Michigan Bd. of Pharmacy, 378 Mich. 430, 146 N.W.2d 1 (1966); Wrigley's Stores, Inc. v. Michigan Bd. of Pharmacy, 336 Mich. 583, 59 N.W.2d 8 (1953).

The National Association of Retail Druggists has suggested that the states adopt a "pharmacy control law" which would permit a pharmacy to be owned only by a registered pharmacist, a partnership of registered pharmacists, or a corporation in which the majority of the board of directors are registered pharmacists. H. WALLER & S. WALLER, PHARMACY OWNERSHIP LEGISLATION, A REPORT PREPARED FOR THE NARD (1964) in F. FLETCHER, MARKET RESTRAINTS IN THE DRUG INDUSTRY 144 (1967).

ing, and writing unnecessary prescriptions,[192] as long as registered pharmacists own the required percentage of the store. Further, the general statutes do not control in-office dispensing, ownership of repackaging companies, or any of the problems connected with the dispensing of eyeglasses.

B. Indirect Control

In addition to statutes restricting the ownership of pharmacies by nonpharmacists, states have devised other statutes which strike in various ways at the doctor-merchant. Pennsylvania, apparently because of its defeat in *Liggett*, and Maryland chose to prohibit physician-owned pharmacies indirectly by controlling from whom a pharmacist may accept employment.[193] In addition, statutes of Arizona,[194] Iowa,[195] and Maryland[196] sanction pharmacists who pay rebates to a medical practitioner in consideration for the referral of patients. Many states,[197] including Mississippi,[198] have statutes providing that a pharmacist's license may be revoked for engaging in conduct contrary to the best interests of the public. If the premise that the doctor-merchant exploits the public is accepted, the pharmacist who accepts employment from such a physician should be found to be violating the public interest.[199]

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[192]These are the three most common effects of allowing physicians to own pharmacies. Brief for the APhA and NARD as Amicus Curiae at 15, North Dakota State Bd. of Pharmacy v. Snyder's Drug Stores, Inc., 414 U.S. 156 (1973).

[193]The Pennsylvania statute provides that a pharmacist's license may be revoked or suspended for grossly unprofessional conduct. It is considered grossly unprofessional conduct for a pharmacist:

> To accept employment as a pharmacist, or share or receive compensation in any form arising out of, or incidental to, his professional activities from any medical practitioner or any other person or corporation in which one or more medical practitioners have a proprietary interest sufficient to permit them to exercise supervision or control over the pharmacist in his professional responsibilities and duties.

PA. STAT. ANN. tit. 63, § 390-5(a)(9) (1968).

The Maryland statute declares it grossly unprofessional conduct sufficient for suspension or revocation of a license for a pharmacist to associate "either as a partner, coowner, or employee of a pharmacy, wholly or substantially owned by a physician, dentist, veterinarian, or other medical practitioner or group thereof . . . ." MD. ANN. CODE art. 43, § 266A(c)(4)(iii) (Supp. 1973).

[194]ARIZ. REV. STATE. ANN. § 32-1927(14)(a) (Supp. 1973).

[195]IOWA CODE ANN. § 155.2 (1972).

[196]MD. ANN. CODE art. 43, § 266A(c)(4)(i) (Supp. 1973).

[197]*E.g.*, NEV. REV. STAT. § 639.210 (1)(d) (1971).

[198]MISS. CODE ANN. § 73-21-39(1)(d) (1972).

[199]A corollary to the "public harm" argument is suggested by MASS. GEN. LAWS ANN. ch. 112, § 39 (Supp. 1973):

> [T]he board may deny such registration and refuse to issue such permit [to a drugstore] if, in its discretion, such store would be inconsistent with or opposed to the best interests of the public health, welfare or safety . . . .

Lilly v. Commissioner[200] presented the Supreme Court with the question of whether an optician could deduct from his taxable income payments made to doctors in consideration for the referral of the doctor's patients. The Court observed that the practice of paying rebates was a nationwide practice and allowed the deduction.[201] The Court did not, however, approve the business ethics that would create such a deduction.[202]

Similar practices have prompted several states to enact statutes making it unlawful to pay or receive any type of rebate connected with dispensing from pharmacies[203] or optical shops.[204] These statutes have been used to prohibit doctor ownership of dispensing facilities.[205]

In *Day v. Inland Empire Optical, Inc.*,[206] a group of ophthalmologists practicing together owned an optical corporation located one floor below their professional offices. The doctors kept a sign in their offices informing patients that there was an optical dispensary below but that prescriptions could be filled elsewhere.[207] Despite the sign, 85 to 90 percent of the doctors' prescriptions were filled at their dispensary.[208] An action was brought alleging that ownership of the dispensary was a violation of the anti-rebating statute.[209] The Washington court held that the distribution of the dispensary's profits and appreciation of its stock amounted to the receipt of a rebate within the meaning of the statute.[210] The doctors, however, were allowed to retain ownership of the dispensary on the condition that they physically separate it from their offices and discontinue the practice of directly or indirectly referring their patients to the dispensary.[211] The court further decided that the statute

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[200]343 U.S. 90 (1951).

[201]*Id.* at 91. *But see* INT. REV. CODE OF 1954, §§ 162(c)(2),(3).

[202]343 U.S. at 97.

[203]*E.g.*, MONT. REV. CODES ANN. § 27-904(b) (Supp. 1973).

[204]OKLA. STAT. ANN. tit. 59, § 944 (1971), *construed in* Williamson v. Lee Optical Co., 348 U.S. 483 (1955). *See also* 16 C.F.R. § 192.7 (1974).

[205]Day v. Inland Empire Optical, Inc., 76 Wash. 2d 566, 456 P.2d 1011 (1969), *noted in* 45 WASH. L. REV. 838 (1970).

[206]76 Wash. 2d 566, 456 P.2d 1011 (1969).

[207]456 P.2d at 1015.

[208]*Id.* 30 to 50 percent of all ophthalmologists in the State of Washington have similar arrangements. *Id.*

[209]After *Day*, the legislature passed the following exception to the statute:

> *Provided*, That ownership of a financial interest in any firm, corporation or association which furnishes any kind of clinical laboratory or other services prescribed for medical, surgical, or dental diagnosis shall not be prohibited under this section where the referring practitioner affirmatively discloses to the patient in writing, the fact that such practitioner has a financial interest in such firm, corporation, or association.

WASH. REV. CODE ANN. § 19.68.010 (Supp. 1973).

[210]456 P.2d at 1018.

[211]*Id.* at 1019.

would permit an ophthalmologist to dispense from his own office through a licensed optician in his employ and under his direct supervision and control.[212]

Oklahoma has a similar statute addressed solely to optometrists and other refractionists,[213] while California[214] and Montana[215] have statutes applicable to rebates from pharmacies. Illinois declares that a physician is guilty of unprofessional conduct if he receives any form of payment from a person, firm, or corporation for professional services he has not actually rendered.[216] Under all of these statutes, it seems that a doctor receives an illegal rebate of the type proscribed in *Day* when he obtains a dividend or a gain by way of stock appreciation from a dispensary in which he has an interest.

Many states have statutes which declare that conduct harmful to the public interest will be a ground for license revocation.[217] Mississippi provides that a physician's license may be revoked or suspended if he engages in "any dishonorable or unethical conduct likely to deceive, defraud or harm the public."[218] The doctor-merchant who overprescribes, writes unnecessary prescriptions, and sends patients to his pharmacy where high prices are charged harms the public. The same is true of the physician who prescribes the brand-name drugs of a repackaging company in which he has a financial interest, especially when better quality or cheaper generic drugs are available. A problem of prohibiting physician ownership of pharmacies and repackaging companies in this indirect manner is that not all of the doctors who have such financial interests actually exploit the patient. The physician who charges the prevailing market price at his pharmacy or repackaging company does not harm the public.[219] For this reason, mere ownership of a pharmacy or repackaging company, in the absence of proof of patient exploitation, would not be sufficient for license revocation.[220] The

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[212]*Id.*

[213]OKLA. STAT. ANN. tit. 59, § 944 (1971).

[214]CAL. BUS. & PROF. CODE § 650 (West Supp. 1973). The statute is violated even when a patient of the doctor is not charged excessively. Mast v. State Bd. of Optometery, 139 Cal. App. 2d 78, 293 P.2d 148 (Dist. Ct. App. 1956).

[215]MONT. REV. CODES ANN. § 27-904(b) (Supp. 1973).

[216]ILL. ANN. STAT. ch. 91, § 16(a)(14) (Smith-Hurd Supp. 1974).

[217]*E.g.*, ILL. ANN. STAT. ch. 91, § 16(a)(4) (Smith-Hurd Supp. 1974) (dishonorable, unethical or unprofessional conduct likely to deceive, defraud or harm the public); MINN. STAT. ANN. § 147.021(1)(g) (Supp. 1974) (unethical, deceptive or deleterious conduct or practice harmful to public); NEV. REV. STAT. § 630.030(11) (1971) (detrimental to best interests of public); PA. STAT. ANN. tit. 63, § 410 (1968) (any pretense which might induce people to become prey to professional exploitation).

[218]MISS. CODE ANN. § 73-25-29(8)(d) (Supp. 1973).

[219]Likewise, a doctor-dispenser who dispenses high-quality drugs from his office at reasonable prices harms no one except his competitors and saves his patient a trip to the drugstore.

[220]Hammel & Myers, *supra* note 4, at 420.

conduct of a physician who abuses ownership for his own financial gain, however, could be violative of these statutes.

C. *Direct Control*

1. Pharmacies - Statutes

A few states have legislated directly against the doctor-merchant by prohibiting physician ownership of dispensaries. California's statute, section 654,[221] was attacked on constitutional grounds in *Magan Medical Clinic v. Board of Medical Examiners*.[222] Three medical partnerships holding proprietary interests in clinic pharmacies and five physicians owning stock in large chain drug corporations sought to have the statute declared unconstitutional under *Liggett*.[223] The court chose to bypass *Liggett* and uphold the statute on the authority of *Williamson v. Lee Optical Co.*[224] The duty of judges, the court held, is not to determine the wisdom of a statute; a statute is constitutional if there is a discernable evil in need of correction and the legislature chose a rational means of correction.[225] The court decided that the statute prohibited both an individual physician and a group of doctors practicing as a partnership from owning pharmacies.[226] The court also held, however, that nothing in the statute prohibits an individual doctor or partnership of doctors from owning the stock of such a corporation.[227]

In *Warrack Medical Center Hospital v. Board of Pharmacy*,[228] a companion case to *Magan*, a hospital corporation sued to compel the state board to issue it a pharmacy permit. The board originally refused to issue a permit because 46.1 percent of the corporation's stock was held by physicians.[229] The issue was whether another regulatory statute, section 4080.5,[230] was intended to prohibit physician ownership of stock in a corporate pharmacy. Section 654 did not apply because it specifically exempts hospital pharmacies from coverage.[231] As to section 4080.5, the court decided that the board lacked the power to "look behind the corporate facade" to determine that the corporation was owned by physicians in violation of that section.[232] Because of the *Magan* holding that

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[221]CAL. BUS. & PROF. CODE § 654 (West Supp. 1973).
[222]249 Cal. App. 2d 124, 57 Cal. Rptr. 256 (Ct. App. 1967).
[223]278 U.S. 105 (1928); *see* discussion of *Liggett* at Part V(*A*) *supra*.
[224]348 U.S. 483 (1955).
[225]57 Cal. Rptr. at 262.
[226]*Id.* at 265.
[227]*Id.*
[228]249 Cal. App. 2d 118, 57 Cal. Rptr. 85 (Ct. App. 1967).
[229]57 Cal. Rptr. at 87.
[230]CAL. BUS. & PROF. CODE § 4080.5 (West Supp. 1973).
[231]57 Cal. Rptr. at 88.
[232]*Id.* at 87-88.

doctors may own stock in corporations which operate pharmacies, the lower court's order that a permit be issued was affirmed.[233]

There are three basic defects in the California statutes. If it is assumed that section 654 was enacted to curtail the abuses detailed in *Magan*,[234] the legislature erred in not specifically prohibiting doctors from owning stock in corporate pharmacies. When a doctor stands to gain from stock appreciation or dividend payments, the temptation to exploit his patients is the same as when he owns a drugstore.[235] Section 654 also exempts doctors who lease buildings to pharmacies on a "percentage of gross income" basis.[236] In such a case, the more drugs a pharmacy dispenses the greater the doctor's rental income will be. Allowing a doctor to enter into such an arrangement encourages the doctor to take measures to increase the pharmacy's drug sales. Finally, section 654 permits physicians to own hospital pharmacies.[237] It is not suggested that there should not be pharmacies in hospitals; the doctors who own the hospital and treat and prescribe for hospital patients, however, should not be tempted to write prescriptions solely to increase the pharmacy's and thereby their own income.

A few other legislatures have enacted statutes directly prohibiting physician ownership of pharmacies.[238] A Nevada statute provides that a license to operate a pharmacy will not be issued to a medical practitioner, partnership, or a corporation in which a medical practitioner has an interest.[239] As in the California statutes, however, a physician may own a hospital pharmacy or a building leased to a pharmacy at the "prevailing rate," whether the rental is a flat monthly rate or a percentage of gross receipts.[240] Montana forbids a physician to own a pharmacy located within 10 miles of the office where he renders professional services, but the statute is silent on whether ownership of a hospital pharmacy or a building leased to a pharmacy is proper.[241] An Arizona statute

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[233] *Id.* at 88.

[234] 57 Cal. Rptr. at 259-62.

[235] *See* Day v. Inland Empire Optical, Inc., 76 Wash. 2d 566, 456 P.2d 1011 (1969).

[236] CAL. BUS. & PROF. CODE § 654 (West Supp. 1973).

[237] *Id.*

[238] Many of the states that have not legislated against physician-owned pharmacies have statutes allowing ownership by nonpharmacists. An example is N.J. STAT. ANN. § 45:14-31 (1963):

> Nothing . . . shall interfere with the ownership of a pharmacy or store, in whole or in part, by a person not a registered pharmacist, if such pharmacy or store is at all times in the charge of a registered pharmacist.

Mississippi has gone further and declared: "Nothing in [the Pharmacy Act] shall be construed to prevent any physician engaged in the practice of his profession from . . . managing his own drugstore . . . ." MISS. CODE ANN. § 73-21-41 (Supp. 1973).

[239] NEV. REV. STAT. § 639.232 (1971).

[240] *Id.*

[241] MONT. REV. CODES ANN. §§ 27-901(e), -904(a) (Supp. 1973).

provides that no permit to operate a pharmacy will be issued or, if a permit has been issued, it will become void, if a medical practitioner receives any form of compensation from the pharmacy related to prescriptions he has written.[242] Again, however, the statute allows a doctor to lease a building to a pharmacy at the "prevailing rate."[243] The Arizona statute is one of the most direct and fair in that it only prohibits a physician from owning a pharmacy where *his* patients have their prescriptions filled. The Arizona Legislature's attempt to be fair, however, has probably rendered the statute difficult to enforce. A violation will be disclosed only if the prescription records of every physician-owned pharmacy in the state are audited to determine if the owner's prescriptions are being filled.

2. Pharmacies - Regulations

There have been attempts to prohibit physician ownership of pharmacies by regulation.[244] In Montana the state pharmacy board, without the aid of statute, determined that a pharmacy permit should not be issued to the Missoula Clinic Pharmacy because 97 percent of the clinic's stock was held by another corporation wholly owned by physicians.[245] The Clinic resorted to the courts. The lower state court found that the board could determine that a license should not be issued. An appeal was taken to the state supreme court where the sole issue was whether the state board had been given authority by the legislature to deny a corporation, indirectly owned by physicians, a pharmacy permit. The court decided that the board was without such authority.[246] The court also observed that the case involved little more than a trade dispute between physicians and pharmacists "garbed in the language of public health and welfare," and that the adverse effect of physician-owned pharmacies on public health "is nebulous if not nonexistent."[247] *Missoula* suggests, however, that the legislature could specifically delegate to the pharmacy board the power to deny pharmacy permits to physicians and corporations owned by physicians.

The Mississippi Legislature has granted the state pharmacy board broad powers to promulgate rules and regulations.[248] The board has exercised its powers by issuing regulations which incorporate the American Pharmaceutical Association Code of Ethics of 1969.[249] Two of the

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[242]ARIZ. REV. STAT. ANN. § 32-1930(B) (Supp. 1973).

[243]*Id.*

[244]F. FLETCHER, MARKET RESTRAINTS IN THE DRUG INDUSTRY 141-44 (1967).

[245]Missoula Clinic Pharmacy v. Zimmerman, 153 Mont. 103, 454 P.2d 619 (1969).

[246]*Id.* at 622.

[247]*Id.*

[248]MISS. CODE ANN. § 73-21-13(a) (1972).

[249]REGULATIONS GOVERNING THE ACTIVITIES OF THE MISSISSIPPI STATE BOARD OF PHARMACY (Recomp. 1973).

regulations are applicable to the physician-owned pharmacy:

> Section 5. A pharmacist should seek at all times only fair and reasonable remuneration for his services. He should never agree to, or participate in transactions with practitioners of other health professions or any other person under which fees are divided or which may cause financial or other exploitation in connection with the rendering of his professional services.
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> . . . .
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> Section 7. A pharmacist should not agree to practice under terms or conditions which tend to interfere with or impair the proper exercise of his professional judgement and skill, which tend to cause a deterioration of the quality of his service or which require him to consent to unethical conduct.[250]

Sections 5 and 7 may prohibit a pharmacist from accepting employment in a pharmacy owned by a medical practitioner. Under section 5, fees are divided when the price a customer pays for a prescription includes a portion of both the salary of the pharmacist-employee and the profit of the physician-owner. Also, a patient's right to purchase his medical needs wherever he desires is destroyed when he is referred by a doctor to his pharmacy. The pharmacist employed by the doctors aids in the exploitation of this captive consumer by dispensing drugs and collecting the price. Section 7 would apply to the physician-owned pharmacy if the doctor-proprietor was requiring the maintainence of an improper drug inventory or otherwise operating the pharmacy in such a way that the exercise of the pharmacist's professional judgment was impaired. Since a regulation prohibiting pharmacists from accepting employment from doctor-merchants is in essence an administrative declaration that physicians may not own pharmacies, the state board might face barriers similar to those in *Missoula* if it were to prohibit pharmacists from working for doctor-merchants. Although the legislature has granted the board broad powers, it has also statutorily recognized the right of a physician to manage his own pharmacy.[251] Unlike *Missoula*, where a regulation was invalidated because the legislature had not expressed a policy *against* physician-owned pharmacies,[252] the pharmacy board regulations in Mississippi would be tested against a legislative policy *authorizing* physician-owned pharmacies.

3. Drug Repackaging Companies

Only one statute addressing the relationship between physicians

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[250] *Id.* art. I, §§ 5, 7. Violation of these regulations will result in suspension or revocation of a pharmacist's license to practice. MISS. CODE ANN. § 73-21-39(1)(c) (1972). No applications of the regulations have been found.

[251] *See* MISS. CODE ANN. § 73-21-41 (Supp. 1973).

[252] Missoula Clinic Pharmacy v. Zimmerman, 153 Mont. 103, 454 P.2d 619 (1969).

and drug repackaging companies has been found. In Montana, a company engaged in the business of manufacturing, processing, packaging, or distributing drugs is considered a "drug company."[253] It is unlawful for a drug company in Montana to give or sell to a medical practitioner a legal or beneficial interest in the company or its income with the intent that the doctor will be induced thereby to prescribe the company's brand name drugs.[254] The same subsection declares that giving or selling such an interest to a doctor before a company's stock has been offered to the general public is prima facie evidence of the company's improper intent. Another subsection prohibits physician ownership of such an interest but allows a doctor to hold for investment purposes the stock of a drug company if the stock has been offered to the general public.[255] A final provision prohibits payment by the drug company or acceptance by a medical practitioner of any type of rebate in consideration for the doctor's prescribing the company's trade-name drugs.[256]

4. Professional Corporations

A question related to the physician-owned pharmacy controversy is whether a professional corporation is prohibited from owning a pharmacy or drug repackaging company by laws limiting the permissible activities of such corporations. Mississippi has declared that:

> No corporation organized under [the Mississippi Professional Corporation Law] shall engage in any business other than the rendering of the professional services for which it was specifically incorporated; provided, however, nothing in [the Professional Corporation Law] . . . shall be interpreted to prohibit such corporation from investing its funds in real estate, mortgages, stocks, bonds, or any other type of investments, or from owning real or personal property necessary for the rendering of professional services.[257]

Forty-two states have enacted statutes of similar purpose and four other states prohibit such corporations from practicing another licensed profession but not from engaging in an unrelated business activity.[258]

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[253]MONT. REV. CODES ANN. § 27-901(f) (Supp. 1973).

[254]*Id.* § 27-902(a).

[255]*Id.* § 27-902(b). This provision permits medical practitioners to have interests in large, national pharmaceutical companies.

[256]*Id.* § 27-902(c). It is probable that more states have not legislated against ownership of drug repackaging companies in the hope that the AMA could deal with the problem. The AMA's position is that it is unethical for a physician to have a financial interest in such a company. JUDICIAL COUNCIL ¶ 47.

[257]MISS. CODE ANN. § 79-9-13 (1972).

[258]Note, *Professional Corporation: Analysis Under the Tax Reform Act and Survey of State Statutes*, 58 GEO.L.J. 487, 516 (1970).

In most states the effect of laws like Mississippi's is still to be decided.[259] The fine line that distinguishes permissible from impermissible corporate activity will be drawn somewhere between conduct characterized as "business" and conduct considered "investment."[260] With regard to the professional corporation owning stock in a repackaging company or corporate pharmacy, the interest held would likely be termed an investment, a permissible corporate activity. When the professional corporation owns and operates a pharmacy on its own premises, however, the distinction becomes harder to draw. The corporation in such a case is intimately connected with the pharmacy; it employs a pharmacist, directs his activities, and is deeply involved in the pharmacy's financial management. It is submitted that activities of this nature are more of a business, therefore, within the proscription of the statute. The other type of professional corporation statute, extant in four states,[261] which prohibits professional corporations from engaging in more than one profession, is silent on whether corporations may hold investments in stocks, real estate, and the like. It is clear, however, that under such statutes a law firm, for example, may not undertake to render both legal and engineering services.[262] If these states recognize dispensing drugs as the practice of the profession of pharmacy, a medical corporation owning and operating a pharmacy would be engaged in the practice of two professions in violation of the statutes. Such a situation, however, could be characterized as a permissible investment in a pharmacy where only a pharmacist practices that profession. It is unlikely that either type of professional corporation law prohibits many of the activities of the corporate doctor-merchant. Most of the ownership situations that tempt the doctor-merchant to exploit patients are more readily characterized as investments than business or professional activities.

5. Physician Dispensing

Physicians in most states are statutorily authorized to dispense drugs and devices from their offices.[263] The form of the Mississippi statute is similar to most other statutes:

> [N]othing in [the Pharmacy Act] shall be construed to prevent any physician engaged in the practice of his profession from compounding

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[259]*See* Dunn, *Professional Corporations: Their Development and Present Status With Respect to the Practice of Medicine*, 24 U. FLA. L. REV. 625, 638 (1972).

[260]Note, *supra* note 258, at 516-17.

[261]*See, e.g.*, ILL. ANN. STAT. ch. 106½, § 101-02 (Smith-Hurd Supp. 1974).

[262]Fleming, *Professional Corporations and Associations in Illinois—Current Status*, 51 CHI. B. RECORD 173, 175 (1970).

[263]*See, e.g.*, OKLA. STAT. ANN. tit. 59, § 353.18 (Supp. 1973).

> his own prescriptions . . . or supplying his patients with such articles as may to him seem proper . . . .[264]

These laws no doubt reflect the opinion of medical associations and state legislatures that dispensing is a prerogative of the physician arising out of the doctor-patient relation.[265] The AMA supports this view, but advises physicians that the better practice would be to forgo dispensing when a local pharmacy is available to the patient.[266] Despite the AMA's ethical plea, a number of doctors engage in the practice.[267] In some cases, however, doctors are finding that it is more expedient to discontinue dispensing than to comply with labeling and recordkeeping laws.[268] A doctor in Michigan, for instance, may sell prescription drugs to his patients only in "a container the label of which bears the name and address of the patient, directions for use, and date of delivery . . . ."[269] Labeling laws are necessary to protect the public health[270] but should not be considered a method of prohibiting dispensing by doctors. They tend only to discourage doctors who dispense in an effort to reduce the price of drugs to their less affluent patients. The abusers, doctors who dispense to increase their incomes, will continue to dispense at prices sufficient to cover the additional employees and time needed to comply with the dispensing laws and ensure a reasonable profit.

A few states have chosen to overrule the AMA and curtail the freedom once enjoyed by the dispensing doctor. In Virginia, a doctor may dispense medication only if the medications are not sold for the doctor's convenience or for the purpose of supplementing the income he receives from rendering professional services.[271] This statute probably means that a physician may dispense when required by the needs of the patient. Montana has enacted legislation, patterned after the proposed federal act,[272] that specifically details the conditions under which drugs

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[264]MISS. CODE ANN. § 73-21-41 (Supp. 1973).

[265]*See* Statement of Marvin Sandler, National Association of Mail Order Pharmaceutical Suppliers, Inc., *1970 Hearings* 68-70. In fact, the practice of dispensing has become prevalent enough to support a number of firms dealing exclusively in the mail-order sale of pharmaceutical supplies to medical practitioners for dispensing to patients. *Id.*

[266]JUDICIAL COUNCIL ¶ 48.

[267]Garcha, *supra* note 19, at 20.

[268]*Id.*

[269]MICH. COMP. LAWS ANN. § 338.1128(a) (Supp. 1974). Federal labeling laws must also be complied with. *E.g.*, 21 U.S.C. §§ 352, 353(b)(2) (1970).

[270]Statement of Philip Sacks, Vice Speaker of the House of Delegates, APhA, *1970 Hearings* 82.

[271]VA. CODE ANN. § 54-524.53 (Cum. Supp. 1974). It is also worthy of note that in Virginia a doctor is guilty of unprofessional conduct if he dispenses drugs, eyeglasses, or medical devices to persons not his own patients, or to his own patients, if his purpose in doing so is to make matters more convenient for himself or to supplement his income. *Id.* § 54-317(12).

[272]S. 1575, 91st Cong., 2d Sess. § 5 (1969).

may be dispensed. A physician may not dispense drugs to patients except in an emergency, in a unit dose, where a local pharmacy is not available, on an occasional basis, or where drug samples are dispensed.[273]

Related to the topic of physician dispensing is reimbursement under the Medicaid Program to physicians who dispense drugs to qualified patients. The original rule establishing that the providers of drugs are eligible for reimbursement read:

> [W]ith respect to 'prescribed drugs,' . . . Federal financial participation is available in expenditures for drugs dispensed by licensed pharmacists or legally authorized practitioners, *where no adequate pharmacy services exist or are available when needed*, and the practitioner dispenses such drugs on his written prescription and retains records thereof.[274]

Many dispensing physicians were dissatisfied with the requirement that adequate pharmacy services must be unavailable, and the AMA and other powerful physicians' organizations succeeded in having the restriction eliminated.[275] The present guideline provides:

> With respect to 'prescribed drugs,' Federal financial participation is available in expenditures for drugs dispensed by licensed pharmacists and licensed authorized practitioners in accordance with the State Medical Practice Act. When dispensing, the practitioner must do so on his written prescription and maintain records thereof.[276]

The Mississippi Medicaid Commission, allows reimbursment to dispensing physicians only if their office is 10 miles or other reasonable distance from a pharmacy or other qualified provider of drugs.[277] Presently, only 11 Mississippi physicians are reimbursed for drugs dispensed.[278] Four of these doctors dispensed less than $10,000 of drugs each, and the remaining seven received reimbursements totaling approximately $225,000, or about two percent of the $12 million paid as reimbursements for drugs dispensed in fiscal 1973.[279] A probable explanation for the small number of doctors participating in the Medicaid Program is that doctors are paid, in addition to the cost of the drugs

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[273]MONT. REV. CODES ANN. § 27-903 (Supp. 1973). See the discussion of section 5 of S. 1575 in Part III *supra* for an analysis of this type of statute.

[274]U.S. BUREAU OF FAMILY SERVICES, DEP'T OF HEW, HANDBOOK OF PUBLIC ASSISTANCE ADMINISTRATION § D-5150 (Supp. D 1966) (emphasis added).

[275]Statement of William E. Woods, *1970 Hearings* 34-36.

[276]45 C.F.R. § 249.10(b)(12)(i) (1973).

[277]Letter from William R. Allen, Drug Program Supervisor, Mississippi Medicaid Commission, to Thomas C. Gerity, June 18, 1974, on file at the *Mississippi Law Journal*.

[278]*Id.*

[279]MISSISSIPPI MEDICAID COMMISSION, ANNUAL REPORT (1973). The largest single reimbursement was for $76,227 to a doctor in Bolivar County. *Id.* 39.

dispensed, a handling fee of only 75 cents for each prescription.[280] This fee is probably inadequate to cover the cost of keeping prescription files, inventory records, and labeling the drugs dispensed.[281] In view of the mileage restrictions and the low fees paid to the doctor-dispensers, it must be concluded that the Mississippi Medicaid Commission is not encouraging doctors to dispense. In other states, particularly those in the Midwest, doctor-dispensing under Medicaid is a "common practice," which should be curtailed either by federal action,[282] or action similar to that taken by the Mississippi Medicaid Commission.

D. Antisubstitution Laws

Ownership by a physician of stock in a drug repackaging company can do no harm unless the physician takes steps to force his patients to buy his company's brand of drugs. This is accomplished by writing a prescription that specifies the brand name his company has applied to a generic drug formula. When the patient takes this prescription to a pharmacist he will receive the brand-name drug of the doctor's repackaging company. A pharmacist is forced to dispense the brand-name drug because of antisubstitution laws.[283] These laws compel pharmacists to dispense trade-name drugs prescribed by doctors; they prohibit a pharmacist from exercising his professional judgment and selecting for the patient a drug manufactured by another company, marketed under a generic or trade name, and which offers the patient either a better quality product or a more reasonable price. Thus, doctors, trying to increase their dividends by prescribing their company's drugs, must rely upon the antisubstitution laws.[284] Antisubstitution laws, however, are not absolute. A physician may delegate the job of product selection to a pharmacist in three ways: (1) He can prescribe a drug by its generic name and thereby permit the pharmacist to dispense the highest quality

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[280]Letter from William R. Allen, *supra* note 277.

[281]*See id.* Pharmacies participating in the Medicaid program are paid $1.75 plus the cost of drugs for each prescription dispensed. *Id.* A recent change in the Medicaid Guidelines allows a person qualified to receive assistance under the program to obtain drugs from any qualified dispenser. 39 Fed. Reg. 2223 (1974). This appears to void the Mississippi Commission's requirement that a physician, to be eligible, must practice at a location 10 miles distant from a pharmacy. The Commission, however, has suggested that a dispending doctor located near other pharmacy services would be reimbursed only for the cost of drugs. Letter from William R. Allen, *supra* note 277.

[282]*See* Statement of William E. Woods, Washington Representative NARD, *1970 Hearings* 32-54. The proposed federal legislation would make reimbursements to dispensing doctors unavailable except in a few circumstances. S. 1575, 91st Cong., 2d Sess. §§ 5, 7 (1969).

[283]*E.g.*, LA. REV. STAT. ANN. § 37:1225(6) (1974).

[284]Statement of Mr. Philip Sacks, Vice Speaker of the House of Delegates, APhA, *1970 Hearings* 83-84.

drug available at the most reasonable price; (2) he can vest in the pharmacist the same power of product selection by prescribing a trade-name drug and noting "or equivalent" on the prescription; or (3) he can prescribe a trade-name drug and consent to a substitute if the pharmacist calls and recommends an alternate product.[285] Of course, a doctor who owns an interest in a repackaging company or who is receiving rebates from such a company for prescribing its drugs[286] can simply prescribe that company's drug by name and his patient will receive it.

Antisubstitution laws are not the result of the efforts of doctor-merchants who own stock in repackaging companies; the laws are merely used by such doctors to increase their company's profits. The laws were first passed in the early 1950's at the insistence of the drug industry to control the growing number of counterfeit drugs appearing in the postwar drug market.[287] Since that time the counterfeits have largely disappeared and other problems have arisen that require reanalysis of the necessity for the present antisubstitution statutes.[288] In 1970 the APhA officially adopted a policy urging the amendment or repeal of these laws.[289] Two points are made by APhA in support of their policy. First, antisubstitution laws presently benefit only the drug industry. Drug salesmen spend a great deal of time selling physicians on the merits of their brand-name products. This promotion causes physicians who have not received the same training with regard to pharmaceutical products as have pharmacists to choose and prescribe a trade-name drug because the company's representative was a superior salesman.[290] Second, the pharmacist, who spends a minimum of five years learning about drugs, is better qualified professionally to choose which company's drug a patient should receive after the physician has prescribed a particular generic drug.[291] The AMA, on the other hand, is opposed to any alteration of the present antisubstitution laws.[292] If these laws are repealed, the doctor-merchant will find it much more difficult to promote his repackaging company's products.

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[285]Bornemeir, *MD's Provide Medical Service and You Offer Pharmaceutical Service*, 37 PHARMACY TIMES, May 1971, at 31.

[286]*See* MONT. REV. CODES ANN. § 27-902(c) (Supp. 1973).

[287]Feldmann, *The Brand Name System—An Intrusion Upon the Profession*, NS11 J. AM. PH. ASS'N 376 (1971).

[288]*Id.* A thorough analysis of antisubstitution laws is beyond the scope of this comment. A comprehensive treatment of the subject may be found in AMERICAN PHARMACEUTICAL ASS'N, A WHITE PAPER ON THE PHARMACIST'S ROLE IN PRODUCT SELECTION (1971).

[289]Feldmann, *supra* note 287.

[290]Statement of Philip Sacks, Vice Speaker of the House of Delegates, APhA, *1970 Hearings* 81.

[291]Feldmann, *supra* note 287, at 377.

[292]AMERICAN PHARMACEUTICAL ASS'N 288, *supra* note 7, at 19.

CONCLUSION

The federal legislation which Senator Hart for 10 years has urged Congress to enact would be very effective in putting an end to doctor-merchants. Federal regulation of an area that traditionally has been regarded as a local matter, however, is a drastic measure in that it is the imposition of federal control on matters of state concern.[293] Each state should at least be afforded the opportunity to regulate medical practitioners within its borders. State legislators appear best equipped to assess the medical needs of their constituents and to tailor their laws in a way that will best meet those needs. Several states have recognized the problem and have taken measures which, it must be assumed, the legislators believed would best serve the interests of their citizens.[294] The Supreme Court gave added force to the argument for state control in *Snyder's*,[295] leaving to the state the decision of who may properly own a pharmacy. *Snyder's* has cleared up constitutional doubts which may have discouraged states from legislating against doctor-merchants. Accordingly, federal legislation should be postponed until it is certain that the states will be unable or unwilling to control doctor-merchants.

Little is known about doctor-merchants in Mississippi. An investigation is needed to determine if they engage in exploitative practices which other states have regarded as serious enough to require corrective legislation. If this is the case, legislation is necessary in Mississippi —legislation that corrects every exploitative practice and leaves no loopholes.

In the absence of facts, it is impossible to predict the type of statute that might be required. The ideal statute, however, would eliminate every medical conflict of interest that has proven injurious to patients and competition. If any doctor-merchant conflict of interest is found to be present in Mississippi, the legislation should take the form of the Hart Bills.[296] Specifically, it should prohibit those licensed to write prescriptions from owning pharmacies or optical dispensaries, leasehold interests in pharmacies and optical dispensaries, and drug repackaging companies.[297] It should prohibit the payment of any type of rebate to a physician. It should deny licentiates the right to dispense drugs, devices,

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[293] *See* Letter from Paul Rand Dixon to Senator Hart, July 8, 1965, in *1967 Hearings* 22.

[294] *E.g.*, CAL. BUS. & PROF. CODE §§ 650, 654, 4080.5 (West Supp. 1973); MD. ANN. CODE art. 43, § 266A(c)(4) (Supp. 1973); MONT. REV.CODES ANN. §§ 27-901 to -906 (Supp. 1973).

[295] 414 U.S. 156 (1973).

[296] Part III *supra*.

[297] General, restrictive ownership laws, like N.D. CENT. CODE § 43-15-35 (Supp. 1973), are probably not the best way to approach the doctor-merchant problem. The general laws do curtail physician ownership of pharmacies, but they also prohibit large corporate pharmacies owned by nonpharmacists. It is submitted that the chain-store pharmacy

or eyeglasses, except in extraordinary circumstances. It should also control optometrists who own optical shops or sell glasses.

Should the Mississippi Legislature discover a need for a doctor-merchant law, the problem of securing its passage arises. Ten years of experience with the Hart Bills has shown that strong opposition to any attempt to correct these medical conflicts of interests can be expected. Concerted action on the part of consumer groups and Mississippi pharmacists' organizations will be necessary to overcome the force that will be exerted by special interest groups.

Thomas C. Gerity

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should not be outlawed, as the economies of scale enable such stores to offer drugs to consumers at lower prices. Arguments for the prohibition of physician ownership of drugstores should not be confused with the arguments pharmacists have made for doing away with corporate drug chains.

RETRIAL AFTER MISTRIAL: THE DOUBLE JEOPARDY DOCTRINE OF MANIFEST NECESSITY

The fifth amendment's provision that no "person be subject for the same offense to be twice put in jeopardy of life or limb"[1] might have been held to apply only after a final verdict had been reached. There is no evidence that the amendment's framers intended this provision to bar retrial after mistrial.[2] The Supreme Court, however, did not so limit the constitutional prohibition against double jeopardy.[3] It realized that in order to protect criminal defendants from an abuse of the government's awesome prosecutorial powers, double jeopardy protection would have to be extended to apply to trials which were aborted after formal proceedings had begun but before a final verdict had been reached. Therefore, the Court held that jeopardy attaches in a jury trial when the jury has been impaneled and sworn,[4] and in a nonjury trial when the court has begun to hear evidence.[5] Under the general rule, once jeopardy has attached, the government is barred from reprosecuting a defendant regardless of whether the trial ended in a verdict or was aborted.[6]

I. Development of the Manifest Necessity Doctrine

A criminal trial is an inherently complicated process, vulnerable to various influences and breakdowns in the judicial machinery that can prevent it from being carried to its conclusion. If there were no exception to the general double jeopardy rule, there would obviously be too great a burden on the government in requiring that it conduct error-free trials. Such a rule would also defeat the ends of public justice by allowing convicted criminals to go unpunished. Therefore, in *Perez v. United States*,[7] the Supreme Court formulated the "manifest necessity" exception to the double jeopardy rule.[8] The Court held that retrial for the

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[1]U.S. Const. amend. V. For a discussion of the history of the double jeopardy rule, see Bartkus v. Illinois, 359 U.S. 121, 151-55 (1959) (Black, J., dissenting).

[2]Note, *Double Jeopardy: The Reprosecution Problem*, 77 Harv. L. Rev. 1272, 1276-77 (1964).

[3]*See, e.g.*, Kepner v. United States, 195 U.S. 100 (1904); Perez v. United States, 22 U.S. (9 Wheat.) 579 (1824).

[4]*E.g.*, Kepner v. United States, 195 U.S. 100 (1904); Bell v. Wainwright, 476 F.2d 964 (5th Cir. 1973) (per curiam); Alexander v. Fogliani, 375 F.2d 733 (9th Cir. 1967); *see* United States v. Dichiarinte, 385 F.2d 333 (7th Cir. 1967); United States v. Collier, 362 F.2d 135 (7th Cir. 1966).

[5]McCarthy v. Zerbst, 85 F.2d 640, 642 (10th Cir.), *cert. denied*, 299 U.S. 610 (1936); *cf.* United States v. Martinez, 350 F. Supp. 971 (W.D. Penn. 1972).

[6]*See* Illinois v. Somerville, 410 U.S. 458 (1973); United States v. Jorn, 400 U.S. 470 (1971); Downum v. United States, 372 U.S. 734 (1963); Gori v. United States, 367 U.S. 364 (1961); Perez v. United States, 22 U.S. (9 Wheat.) 579 (1824).

[7]22 U.S. (9 Wheat.) 579 (1824).

[8]When Justice Story formulated this rule, reprosecution was permitted because no

same offense is not prohibited where the trial judge has aborted the trial prior to verdict when, taking all of the circumstances into consideration, "there is a manifest necessity for the act, or the ends of public justice would be otherwise defeated."[9] The Court vigorously warned that the power should be used with caution and only in extraordinary circumstances.[10]

The Supreme Court had little trouble finding the required "manifest necessity" in cases where trials could not be completed due to breakdowns in judicial machinery or outside influences which were not under the control of the trial judge or the parties. Early Supreme Court cases allowed reprosecution after mistrial where it was discovered during the trial that a juror had lied during voir dire examination,[11] where the jury was unable to agree on a verdict,[12] where it was discovered during trial that a juror was disqualified because he had been a member of the grand jury which had returned the indictment in that case,[13] and where a court-martial had to be terminated due to the tactical situation of an army in the field.[14] Since 1960 the Supreme Court has attempted to delineate further the "manifest necessity" exception in order to provide trial judges guidance for determining when they may abort a trial without insulating the defendant from further prosecution.[15]

In *Gori v. United States*,[16] the Court first undertook to define the manifest necessity exception. The trial judge, of his own motion, declared a mistrial because he believed that the prosecutor's line of questioning was calculated to bring inadmissible evidence before the jury. In a 5-4 decision, the Court held that the trial judge had not abused his discretion even though no objectionable evidence had actually been introduced. The Court stated that it had always recognized a wide discretion in trial judges to declare mistrials where manifestly necessary, and

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verdict had been entered to bring double jeopardy into play, and the trial judge's oath of office was viewed as the only restraint on his discretion to declare a mistrial. But when the double jeopardy rule was extended to apply from the time that a jury was impaneled and sworn or a court sitting without a jury began to hear evidence, Justice Story's "manifest necessity" rule was adopted as the standard for determining when the double jeopardy clause permitted reprosecution following an aborted trial. Note, *supra* note 2, at 1276-77.

[9]22 U.S. (9 Wheat.) at 580.

[10]*Id.*

[11]Simmons v. United States, 142 U.S. 148 (1891).

[12]Keerl v. Montana, 213 U.S. 135 (1909); Dreyer v. Illinois, 187 U.S. 71 (1902); Logan v. United States, 144 U.S. 263 (1892).

[13]Thompson v. United States, 155 U.S. 271 (1894).

[14]Wade v. Hunter, 336 U.S. 684 (1949).

[15]Illinois v. Somerville, 410 U.S. 458 (1973); United States v. Jorn, 400 U.S. 470 (1971); Downum v. United States, 372 U.S. 734 (1963); Gori v. United States, 367 U.S. 364 (1961).

[16]367 U.S. 364 (1961).

intimated that it would find abuse of this discretion only where the government was attempting to harass the defendant or where a mistrial had been declared in order to afford the prosecution a more favorable opportunity to convict.[17] The four dissenting judges objected strongly to this holding, characterizing it as a diminution of the individual's constitutional right not to be twice placed in jeopardy for the same offense.[18] The dissenters believed that the double jeopardy clause should stand as a bar to all retrials except where the trial judge, after a careful scrutiny of all reasonable alternatives, had found a manifest necessity for declaring a mistrial.[19] Here, the trial judge had not only failed to consider other reasonable and less drastic alternatives to a mistrial, but had declared the mistrial before the prosecutor had asked an objectionable question.

In *Downum v. United States*,[20] the prosecutor allowed a jury to be impaneled and sworn despite the absence of a chief government witness. The trial judge granted the prosecutor's motion for a mistrial and two days later the defendant was tried before a second jury and convicted. The Court reversed that conviction and adopted what was essentially the position of the dissent in *Gori*: the Court declared that a mistrial granted to furnish a more favorable opportunity to convict the defendant is clearly impermissible.[21]

In *United States v. Jorn*,[22] the defendant was tried for willfully assisting in the preparation of fraudulent income tax returns. At the defense counsel's suggestion, the judge warned one of the witnesses of his fifth amendment rights. The witness continued to express a willingness to testify, but the judge refused to allow the testimony until he had consulted with an attorney. After the prosecutor announced his intention to call four additional, similarly situated witnesses, the trial judge discharged the jury in order to afford these five witnesses an opportunity to consult with counsel. The Court explained that reprosecution after an unnecessarily declared mistrial subjects a defendant to the same strain regardless of the trial judge's motivation. Great emphasis was placed upon a defendant's valued right to have his trial completed by a particular tribunal.[23] Stressing this "valued right," the Court declared that even in cases totally void of any intimation of prosecutorial or

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[17] *Id.* at 369.

[18] *Id.* at 370 (Douglas, Black & Brennan, JJ., & Warren, C.J., dissenting).

[19] "Once . . . jeopardy attaches . . . a subsequent prosecution is barred, if a mistrial is ordered—absent a showing of imperious necessity." *Id.* at 371.

[20] 372 U.S. 734 (1963) (the first case in which the Supreme Court held that the double jeopardy clause barred reprosecution following the abortion of the original trial prior to verdict).

[21] *Id.* at 737, *citing* Cornero v. United States, 48 F.2d 69 (9th Cir. 1931).

[22] 400 U.S. 470 (1971).

[23] *Id.* at 480, *citing* Wade v. Hunter, 336 U.S. 684, 689 (1949).

judicial overreaching, the double jeopardy clause stands as a command to trial judges not to foreclose a defendant's option to have his case decided by the first jury chosen, unless a scrupulous exercise of judicial discretion leads to the conclusion that a continuation of the trial would run counter to the ends of public justice. Applying this interpretation of the manifest necessity exception, the Court held that in the instant situation reprosecution was barred.

Prior to *Downum* and *Jorn*, trial judges enjoyed an almost unfettered discretion to declare mistrials without insulating the defendant from further prosecution.[24] These cases, however, require trial judges to consider all reasonable alternatives and to decide if the circumstances which have precipitated the need for the abortion of the trial outweigh the defendant's right to have his case decided by the first jury chosen.[25]

The Burger Court rendered its first interpretation of this line of cases in *Illinois v. Somerville*.[26] The defendant had been indicted by an Illinois grand jury for theft. After a jury had been impaneled and sworn, but before any evidence had been presented, the prosecutor realized that the indictment was fatally deficient under Illinois law.[27] The Court recognized that this procedural error could not be corrected by an alternative less drastic than a mistrial because of the state's rigid procedural rules.[28] An attempt was made to distinguish *Downum* and *Jorn* by explaining that the mistrial delay did not operate to allow the prosecutor to strengthen his case and that there were no less drastic alternatives available.

The Court declared that a manifest necessity exists if an impartial verdict cannot be reached and if a verdict of conviction would be overturned upon appeal.[29] The Court recognized that a possibility of prosecutorial manipulation would present a different question, but specifically found that this question was not involved here.[30] This finding of

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[24]*See, e.g.*, Scott v. State, 110 Ala. 48, 20 So. 468 (1896); State v. Pace, 210 Miss. 448, 49 So. 2d 710 (1951); State v. Collins, 115 N.C. 716, 20 S.E. 452 (1894); *cf.* State v. Bilton, 156 S.C. 324, 153 S.E. 269 (1930). *See also* Note, *supra* note 2, at 1277.

[25]United States v. Jorn, 400 U.S. 470 (1971); Downum v. United States, 372 U.S. 734 (1963).

[26]410 U.S. 458 (1973) (5-4 decision).

[27]The indictment was defective because it did not assert that the defendant intended to deprive the owner of his property permanently. *Id.* at 459.

[28]The combined operation of the following rules of Illinois procedural and substantive law were applicable: (1) by virtue of criminal statute, allegation of the proper intent is a necessary element of the crime of theft, and failure to allege such intent makes the indictment insufficient to charge a crime; (2) under the Illinois Constitution, an indictment is the only means by which a criminal proceeding for theft may be commenced; (3) due to Illinois procedural law, only formal defects, of which this was not one, may be cured by an amendment to the indictment. *Id.* at 459-60.

[29]*Id.* at 464.

[30]*Id.*

no prosecutorial manipulation was the focal point of the two dissenting opinions.[31] It was pointed out that the inability to amend an indictment can necessitate a mistrial only after the state has made an error in drafting that indictment.[32]

The effect of *Somerville* on the Warren Court's trilogy is uncertain. The language of the cases is the same; it is the facts which are troubling. One conclusion, however, is clear: the Court is now much less inclined to find a possibility of prosecutorial manipulation than had been indicated by its previous decisions. It is this more lenient attitude which *Somerville* portends.

II. Application of the Doctrine of Manifest Necessity

Double jeopardy opinions strongly warn against categorizing the cases and against formulating strict guidelines to be used in the resolution of the intricate manifest necessity problems which consistently arise.[33] Some comparison of the lower federal cases is nevertheless prerequisite to discerning the nuances which are essential to intelligent and proficient utilization of the doctrine of manifest necessity. Such a comparison teaches that certain circumstances create an implied waiver of double jeopardy and that others establish presumptions either in favor of or against allowing retrial. The ability to recognize and deal with the concepts of waiver and presumption is indispensable to the competent handling of a double jeopardy mistrial case.

A. Waiver of the Right to Plead Double Jeopardy

1. No Former Jeopardy Plea Entered at Second Trial

"The constitutional immunity from double jeopardy is a personal right which, if not affirmatively pleaded by the defendant at the time of trial, will be regarded as waived."[34] This implied waiver existed as a trap for ignorant defendants; for this reason there has been an increasing break in the rule. Courts now require a knowing waiver of double jeopardy before they deny a defendant access to one of his fundamental

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[31]*Id.* at 471 (White, Douglas & Brennan, JJ., dissenting); *Id.* at 477 (Marshall, J., dissenting).

[32]*Id.* at 482.

[33]"Each case must turn on its own facts." Downum v. United States, 372 U.S. 734, 737 (1963); *accord*, United States v. Moon, 491 F.2d 1047, 1049 (5th Cir. 1974); United States *ex rel.* Russo v. Superior Court, 483 F.2d 7, 13 (3d Cir.), *cert. denied*, 414 U.S. 1023 (1973); McNeal v. Hollowell, 481 F.2d 1145, 1147 (5th Cir. 1973), *cert. denied*, 415 U.S. 951 (1974); United States *ex rel.* Peetros v. Fundle, 342 F. Supp. 55, 58 (E.D. Pa. 1972), *aff'd*, 478 F.2d 1399 (3d Cir. 1973).

[34]United States v. Scott, 464 F.2d 832, 833 (D.C. Cir. 1972); *accord*, United States v. Buonomo, 441 F.2d 922 (7th Cir. 1971).

rights.[35] Not many defendants will knowingly waive a meritorious defense; therefore, it would seem that the standard of proof for such a waiver is necessarily high and must be borne by the government. Although this rule has begun to crumble, waiver is still imputed to one who pleads guilty at his second trial.[36] Unless the prosecution can prove that a defendant knowingly waived his right to plead double jeopardy, the courts should give the same close scrutiny to every defendant's constitutional claims.

2. Mistrial Motion by Defendant

Courts have consistently refused to hear assertions of double jeopardy if the mistrial motion is made by the defendant.[37] Even if the defendant's motion is initiated by prosecutorial error,[38] and especially if it arises from a neutral cause,[39] the courts do not consider the double jeopardy problems.[40] Only upon proof of prosecutorial "misconduct or over-

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[35]McNeal [the defendant] was not informed by his attorney or anyone else, that he could not be twice placed in jeopardy for the same offense, and that such was prohibited by the double jeopardy clause of the Fifth Amendment to the Constitution of the United States. Under the circumstances, it is clear that the petitioner did not waive his right to subsequently raise a claim of former jeopardy.

McNeal v. Collier, 353 F. Supp. 485, 489 (N.D. Miss. 1972), *rev'd on other grounds sub nom.* McNeal v. Hollowell, 481 F.2d 1145 (5th Cir. 1973), *cert. denied*, 415 U.S. 951 (1974), *citing* Johnson v. Zerbst, 304 U.S. 458 (1938), *and* Winters v. Cook, 466 F.2d 1393 (5th Cir. 1973); *accord*, United States v. LeMay, 330 F. Supp. 628 (D. Mont. 1971); United States v. Armco Steel Corp., 252 F. Supp. 364 (S.D. Cal. 1966).

[36]Cox v. Kansas, 456 F.2d 1279 (10th Cir. 1972); United States *ex rel.* Cooper v. Zelker, 339 F. Supp. 410 (S.D.N.Y. 1972).

[37]*E.g.*, United States v. Beasley, 479 F.2d 1124 (5th Cir.), *cert. denied*, 414 U.S. 924 (1973); United States v. Iacovetti, 466 F.2d 1147 (5th Cir. 1972), *cert. denied*, 410 U.S. 908 (1973); Gregory v. United States, 410 F.2d 1016 (D.C. Cir.), *cert. denied*, 396 U.S. 865 (1969); United States v. Franke, 409 F.2d 958 (7th Cir. 1969), *cert. denied*, 402 U.S. 943 (1970); Vaccaro v. United States, 360 F.2d 606 (5th Cir. 1966); United States *ex rel.* Cooper v. Zelker, 339 F. Supp. 410 (S.D.N.Y. 1972); *see* McNeal v. Hollowell, 481 F.2d 1145 (5th Cir. 1973), *cert. denied*, 415 U.S. 951 (1974); United States *ex rel.* Montgomery v. Brierley, 414 F.2d 552 (3d Cir.), *cert. denied*, 399 U.S. 912 (1969); United States v. Hibbs, 356 F. Supp. 820 (E.D. Pa. 1973).

[38]United States v. Romano, 482 F.2d 1183 (5th Cir.), *cert. denied*, 414 U.S. 971 (1973); Roberts v. United States, 477 F.2d 544 (8th Cir. 1973) (per curiam); United States v. Iacovetti, 466 F.2d 1147 (5th Cir. 1972), *cert. denied*, 410 U.S. 908 (1973); United States v. Henderson, 439 F.2d 531 (D.C. Cir. 1970) (per curiam).

[39]United States v. Goldstein, 479 F.2d 1061 (2d Cir.), *cert. denied*, 414 U.S. 873 (1973); United States v. Kwitek, 467 F.2d 1222 (7th Cir.), *cert. denied*, 409 U.S. 1079 (1972); United States v. Pappas, 445 F.2d 1194 (3d Cir.), *cert. denied*, 404 U.S. 984 (1971); United States *ex rel.* Peetros v. Rundle, 342 F. Supp. 55 (E.D. Pa. 1972), *aff'd*, 478 F.2d 1399 (3d Cir. 1973); Hairston v. Slayton, 333 F. Supp. 197 (W.D. Va. 1971).

[40]*See* notes 37 through 39 *supra*.

reaching" will the courts examine the claim.[41] It is difficult to believe that the substantive rights of defendants may be determined by which attorney first gains the attention of the trial judge to move for mistrial.

The death knell of this pro forma doctrine was recently sounded in three circuits.[42] Each court was presented with fact situations which demonstrated the injustice of the strict rule.[43] In their quest to determine if the right to plead double jeopardy had in fact been waived, the courts looked beyond the fact that the defendants had moved for the mistrial.[44]

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[41][W]here circumstances develop not attributable to prosecutorial or judicial overreaching, a motion by defendants for mistrial is ordinarily assumed to remove any barrier to reprosecution, even if the defendant's motion is necessitated by prosecutorial or judicial error.

United States v. Romano, 482 F.2d 1183, 1188 (5th Cir.), *cert. denied*, 414 U.S. 971 (1973), *quoting* United States v. Jorn, 400 U.S. 470, 485 (1971). *See also* United States v. Iacovetti, 466 F.2d 1147 (5th Cir. 1972), *cert. denied*, 410 U.S. 908 (1973); United States v. Lansdown, 460 F.2d 164 (4th Cir. 1972); United States v. Henderson, 439 F.2d 531 (D.C. Cir. 1970); Gregory v. United States, 410 F.2d 1016 (D.C. Cir. 1969).

[42]United States v. Dinitz, 492 F.2d 53 (5th Cir. 1974); United States *ex rel.* Russo v. Superior Court, 483 F.2d 7 (3d Cir.), *cert. denied*, 414 U.S. 1023 (1973); United States v. Walden, 448 F.2d 925 (4th Cir. 1971), *cert. denied*, 409 U.S. 867, *district court aff'd on rehearing by an equally divided court*, 458 F.2d 36 (4th Cir. 1972) (en banc), *cert. denied*, 410 U.S. 969 (1973).

[43]In *Dinitz* the defendant was represented by a law student supervised by a professor. The student was dismissed from the case for statements made during his opening remarks. (The court also determined that this dismissal was unnecessary.) Not having prepared the case, the supervising professor was left with no choice but to move for a mistrial.

In *Russo* the jury had deliberated for several hours when the defendant moved for a mistrial which was denied. Subsequently the jury requested certain material which indicated they might be close to reaching a verdict of acquittal. Regardless of the possible verdict, however, the request was sufficient to have encouraged the defendant to change his mind about the mistrial. The next day the judge summoned the jury and without warning discharged them and dismissed the case. The dismissal was so abrupt that the defense attorney was able to object only in the judge's chambers after the dismissal. The judge, however, claimed that the defendant had moved for mistrial the day before.

In *Walden* two jurors possibly saw some of the defendants in handcuffs. Some of the defendants moved for mistrial at the judge's invitation; others objected. To follow the usual rule the reviewing court would have had to set free those defendants whose attorneys had possessed the presence of mind to object, but send to jail those whose attorneys had affirmatively responded to the judge's request for a mistrial motion.

In each case, *Dinitz*, *Russo*, and *Walden*, the courts held that the mistrial motions did not waive the defendants' rights to plead double jeopardy. Although *Walden* was the precursor of this new approach to waiver, the Fourth Circuit en banc reversed this exceptionally well-reasoned opinion by affirming by an evenly divided vote the district court's second conviction of all defendants. United States v. Walden, 458 F.2d 36 (4th Cir. 1972). This final opinion was only one paragraph long and did not attempt to grapple with the sound rationale of the original *Walden* appellate decision.

[44]Using a defendant's consent to a mistrial to bar his subsequent complaint of double jeopardy implies that he has bound himself to accept an abandonment of the first trial by exercising something more substantial than a Hobson's choice.

United States v. Dinitz, 492 F.2d 53, 59 (5th Cir. 1974).

They examined the entire situation and found that either no choice but to make the motion was open to the defendants[45] or that no motion for mistrial was actually made.[46] The courts all declared that the defendants had not waived their rights; however, the real significance of the decisions was the willingness of the courts to look beyond which party moved for the mistrial.[47]

If the court refuses to take this approach, a double jeopardy claim based upon a mistrial declared at the urging of the defendant will only be considered if prosecutorial manipulation or overreaching was involved.[48] To meet this burden one must prove "gross negligence or intentional misconduct."[49] Since such blatant conduct by the prosecutor would usually result in sua sponte mistrial declaration, the burden is almost impossible to meet. Helpful indicators of such conduct include evidence of the prosecutor's desire not to continue with the trial and examples of the prosecutor's having gained an advantage by revealing new evidence at the second trial.[50]

3. Circumstances Created by Defendant

Reviewing courts also find a waiver of rights when the defendant created the circumstances which demand the mistrial.[51] The Fifth Cir-

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> Whether there was 'consent' to the declaration of a mistrial involves varying and entirely different fact considerations. We think the time has come to inquire into such circumstances and to reject a flat rule that mere mouthing of the motion in open court constitutes in every case waiver of a subsequent plea in bar.

United States v. Walden, 448 F.2d 925, 930 (4th Cir. 1971).

[45]United States v. Dinitz, 492 F.2d 53, 59 (5th Cir. 1974); United States v. Walden, 448 F.2d 925, 930 (4th Cir. 1971).

[46]"We see no reason to lock him [the defendant] into a motion once it is made." United States *ex rel.* Russo v. Superior Court, 483 F.2d 7, 17 (3d Cir. 1973).

[47]*But see* Roberts v. United States, 348 F. Supp. 563 (E.D. Mo. 1972). This decision narrowly interpreted *Walden* and specifically limited its interpretation of the case to the facts before that court. Therefore, in *Roberts* the court found waiver solely because all the defendants made the motion for the mistrial.

[48]*See* note 41 *supra*.

[49]United States v. Beasley, 479 F.2d 1124, 1127 (5th Cir. 1973).

[50]*Id.*

[51][A] defendant who actively engages in a course of conduct calculated to necessitate the granting of a mistrial, but who does not actually request a mistrial, is similarly barred from relying on a double jeopardy defense at a second trial.

McNeal v. Hollowell, 481 F.2d 1145, 1151 (5th Cir. 1973), *cert. denied*, 415 U.S. 951 (1974); *see* United States v. Jorn, 400 U.S. 470, 487-88 (1971); United States v. Pridgeon, 462 F.2d 1094 (5th Cir. 1972) (per curiam); United States v. Walden, 448 F.2d 925, 929 (4th Cir. 1971), *cert. denied*, 409 U.S. 867, *district court aff'd on rehearing by an equally divided court*, 458 F.2d 36 (4th Cir. 1972) (en banc), *cert. denied*, 410 U.S. 969 (1973); Loux v.

cuit, however, recently moved to narrow this quasi-waiver doctrine.[52] The lower court held that retrial of a particular defendant was not barred because the defendant had created the situation which resulted in the mistrial.[53] The reviewing court pointed out that there were other causes of the mistrial, that there was nothing improper in the activities of the defendant, and that there was a possibility for prosecutorial manipulation if the mistrial were to be allowed.[54] Once again the court expressed its willingness to examine the entire factual situation and not to be placated by a fictional theory of implied waiver due to the defendant's actions.

B. Presumptions of Manifest Necessity

1. Mistrials Due to "Hung Juries"

The presumption that a manifest necessity exists for declaring a mistrial whenever a jury is unable to reach a verdict is well established in the case law.[55] There are, however, two means of overcoming this presumption. The first is to convince the court that the number of mistrials has become too burdensome for any defendant to bear.[56] The second is to prove that the trial judge never actually determined that the jury was unable to reach a verdict.[57] The burden of proof for each of

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United States, 389 F.2d 911, 921 (9th Cir.), *cert. denied*, 393 U.S. 867 (1968); *cf.* Carsey v. United States, 392 F.2d 810 (D.C. Cir. 1967). *See also* United States v. Moon, 491 F.2d 1047 (5th Cir. 1974).

[52]McNeal v. Hollowell, 481 F.2d 1145 (5th Cir. 1973), *cert. denied*, 415 U.S. 951 (1974), *rev'g sub nom.* McNeal v. Collier, 353 F. Supp. 485 (N.D. Miss. 1972).

[53]353 F. Supp. at 490.

[54]481 F.2d at 1145.

[55]"The law is clear that the defense of double jeopardy does not apply where the jury is unable to agree on a verdict." United States v. Medina, 323 F. Supp. 1277 (E.D. Pa. 1971); *accord*, United States v. Berniker, 439 F.2d 687 (9th Cir. 1971); Grogan v. United States, 394 F.2d 287 (5th Cir. 1967), *cert. denied*, 393 U.S. 830 (1968); Rothaus v. United States, 319 F.2d 528 (5th Cir. 1963); Gilmore v. United States, 264 F.2d 44 (5th Cir.), *cert. denied*, 359 U.S. 994 (1959); Moore v. Cardwell, 367 F. Supp. 1191 (D. Ariz. 1973); Price v. Slayton, 347 F. Supp. 1269 (W.D. Va. 1972); Hernandez v. Nelson, 298 F. Supp. 682 (N.D. Cal.), *aff'd*, 411 F.2d 619 (9th Cir. 1968).

[56]The public interest in seeing that a crime does not go unpunished is not an interest without limitation. To express that interest more accurately, there is a public interest in seeing to it that evidence of a crime is fully presented at a fair trial to a fairly selected jury . . . . There the public interest ends, for that interest does not equate conviction with justice.

United States v. Castellanos, 349 F. Supp. 720, 723 (E.D.N.Y. 1972); *accord*, Preston v. Blackledge, 332 F. Supp. 681 (E.D.N.C. 1971).

[57]"Before the defendant loses his Fifth Amendment right, we think that the trial judge must at least determine whether the jury is approaching a verdict." United States *ex rel.* Russo v. Superior Court, 483 F.2d 7, 13 (3d Cir.), *cert. denied*, 414 U.S. 1023 (1973); *accord*, United States v. Lansdown, 460 F.2d 164 (4th Cir. 1972).

these approaches rests with the defendant.[58]

2. Mistrial Because of Juror Contamination

Although *Jorn* flatly rejects allowing retrial whenever the mistrial is declared to benefit the defendant and demands that the manifest necessity standard must always be met,[59] remnants of that practice still exist. Reviewing courts are predisposed to allow retrial whenever the judge has declared mistrial because of suspicion that a juror has been contaminated.[60] The Fourth Circuit recently overruled a lower court judge's declaration of double jeopardy in such a situation citing a line of cases wherein "the reviewing court[s] did not require the judge to determine whether the communication had in fact prejudiced the juror . . . [but only] that a juror had received an improper communication."[61] It is not necessary to prove juror bias; proof of contamination will justify a mistrial.

More than "a reasonable apprehension that a trial is flawed" must be shown before a manifest necessity will be found to exist.[62] Just how much more is not clear, but this is the only indication of the degree of suspicion necessary to justify a mistrial because of juror contamination.

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[58]*See* United States *ex rel.* Russo v. Superior Court, 483 F.2d 7 (3d Cir.), *cert. denied*, 414 U.S. 1023 (1973); United States v. Lansdown, 460 F.2d 164 (4th Cir. 1972); United States v. Castellanos, 349 F. Supp. 720 (E.D.N.Y. 1972); Preston v. Blackledge, 332 F. Supp. 681 (E.D.N.C. 1971).

[59]United States v. Jorn, 400 U.S. 470 (1971).

[60]*See, e.g.*, Simmons v. United States, 142 U.S. 148 (1891); Thompson v. United States, 155 U.S. 271 (1894); United States v. Chase, 372 F.2d 453 (4th Cir. 1967); United States v. Smith, 390 F.2d 420 (4th Cir. 1968). In each of these cases, after the jury had been impaneled and sworn, the trial judge received information which rendered suspect the ability of one or more of the jurors to reach an impartial verdict. The exercise of the trial judge's discretion in declaring a mistrial was upheld, and reprosecution was permitted over objections based on the double jeopardy clause. Significantly, in each case, after the trial judge had ascertained that a juror had received an improper communication, the reviewing court did not require the judge to determine whether the communication had in fact prejudiced the juror. Discovery of the harmful communication itself afforded grounds for mistrial.

Whitfield v. Warden of Md. House of Corrections, 486 F.2d 1118, 1122 (4th Cir. 1973); *accord*, Smith v. Mississippi, 478 F.2d 88 (5th Cir.), *cert. denied*, 414 U.S. 1113 (1973); United States v. Kwitek, 467 F.2d 1222 (7th Cir.), *cert. denied*, 409 U.S. 1079 (1972); United States v. Pridgeon, 462 F.2d 1094 (5th Cir. 1972) (per curiam); United States *ex rel.* Peetros v. Rundle, 342 F. Supp. 55 (E.D. Pa. 1972), *aff'd*, 478 F.2d 1399 (3d Cir. 1973).

[61]Whitfield v. Warden of Md. House of Corrections, 486 F.2d 1118, 1122 (4th Cir.), *rev'g* 355 F. Supp. 972 (D. Md. 1973).

[62]United States v. Walden, 448 F.2d 925, 930 (4th Cir. 1971), *cert. denied*, 409 U.S. 867, *district court aff'd on rehearing by an equally divided court*, 458 F.2d 36 (4th Cir. 1972) (en banc), *cert. denied*, 410 U.S. 969 (1973).

3. Mistrial Because of Neutral Causes

Whenever a situation necessitating possible mistrial arises which is completely beyond the control of either the prosecutor or the courts, there is an inclination to find that the mistrial was proper and to allow the retrial of the defendant.[63] These cases usually are precipitated by ill health of the defendant, a juror, or members of their family.[64]

C. Presumption That a Manifest Necessity Does Not Exist

1. The Possibility of Prosecutorial Manipulation

Whenever a defendant is able to raise the possibility of prosecutorial manipulation, the reviewing court will presume that no manifest necessity exists.[65] Factors indicative of possible manipulation include: whether the prosecutor moved for or was in favor of the mistrial;[66] whether the prosecutor was responsible for the circumstances which required the mistrial;[67] whether the mistrial came at a time when the prosecutor knew that his case was going badly;[68] and whether the prosecutor strengthened his case for the second trial.[69]

Fear of the prosecution repeatedly inducing mistrials until the state believes it has a good chance for gaining conviction was a primary moti-

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[63]*E.g.*, Featherston v. Mitchell, 481 F.2d 582 (5th Cir. 1969), *cert. denied*, 397 U.S. 937 (1970); Loux v. United States, 389 F.2d 911 (9th Cir.), *cert. denied*, 393 U.S. 867 (1968); Oelke v. United States, 389 F.2d 668 (9th Cir. 1967), *cert. denied*, 390 U.S. 1029 (1968); Hairston v. Slayton, 333 F. Supp. 197 (W.D. Va. 1971).

[64]*E.g.*, Loux v. United States, 389 F.2d 911 (9th Cir.), *cert. denied*, 393 U.S. 867 (1968); Hairston v. Slayton, 333 F. Supp. 197 (W.D. Va. 1971).

[65]Downum v. United States, 372 U.S. 734 (1963); McNeal v. Hollowell, 481 F.2d 1145 (5th Cir. 1973), *cert. denied*, 415 U.S. 951 (1974); United States v. LeMay, 330 F. Supp. 628 (D. Mont. 1971); *see* United States v. Cheung, 485 F.2d 689 (5th Cir. 1973); *cf.* United States *ex rel.* Bland v. Nenna, 282 F. Supp. 754 (S.D.N.Y.), *aff'd*, 393 F.2d 416 (2d Cir.), *cert. denied*, 392 U.S. 941 (1968). *But see* United States v. Iacovetti, 466 F.2d 1147 (5th Cir. 1972), *cert. denied*, 410 U.S. 908 (1973); United States v. Henderson, 439 F.2d 531 (D.C. Cir. 1970) (per curiam); United States v. Franke, 409 F.2d 958 (7th Cir. 1969), *cert. denied*, 402 U.S. 943 (1971). In these three cases the situation requiring the mistrial was created by the prosecutor; however, the defendants' mistrial motions were found to waive their rights to assert double jeopardy.

[66]McNeal v. Hollowell, 481 F.2d 1145 (5th Cir. 1973), *cert. denied*, 415 U.S. 951 (1974); United States v. Beasley, 479 F.2d 1124, 1127 (5th Cir.), *cert. denied*, 414 U.S. 924 (1973).

[67]McNeal v. Hollowell, 481 F.2d 1145 (5th Cir. 1973), *cert. denied*, 415 U.S. 951 (1974); United States v. LeMay, 330 F. Supp. 628 (D. Mont. 1971); *cf.* United States *ex rel.* Bland v. Nenna, 232 F. Supp. 754 (S.D.N.Y.), *aff'd*, 383 F.2d 416 (2d Cir.), *cert. denied*, 392 U.S. 941 (1968).

[68]United States v. Romano, 482 F.2d 1183, 1188 (5th Cir.), *cert. denied*, 414 U.S. 971 (1973).

[69]McNeal v. Hollowell, 481 F.2d 1145 (5th Cir. 1973), *cert. denied*, 415 U.S. 951 (1974); United States v. Beasley, 479 F.2d 1124, 1127 (5th Cir. 1973), *cert. denied*, 414 U.S. 924 (1973); *see* United States v. Tanner, 471 F.2d 128 (7th Cir. 1972).

vation behind the development of the doctrine of manifest necessity.[70] Therefore, courts often refuse to allow retrial upon proof of even a possibility of prosecutorial manipulation.[71]

2. The Possibility of Judicial Overreaching

Although there seems to exist no presumption that a mistrial caused by the actions of a trial judge will bar retrial, there usually is very close scrutiny of the entire factual situation in such instances.[72] Recently courts have even expressed their skepticism of mistrials declared upon motions by the defendant which are invited from the bench.[73]

III. Utilizing the Doctrine of Manifest Necessity

The doctrine of manifest necessity holds that retrial after mistrial is barred unless a manifest necessity for the mistrial exists.[74] Courts have struggled with defining "manifest necessity" ever since *Perez v. United States*[75] was decided in 1824; its meaning, however, is simple: a manifest necessity is forged whenever there is no reasonable alternative to the declaraton of a mistrial.[76] Quite often, however, the alternative which should be exercised is the continuance of the original trial regard-

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[70]*See* Note, *supra* note 2, at 1275-76.

[71]*E.g.*, United States v. Cheung, 485 F.2d 689 (5th Cir. 1973).

[72]"Since the court's actions at the time . . . made the subsequent grant of a mistrial inevitable, appellate review must center on these actions . . . ." United States v. Dinitz, 492 F.2d 53, 59 (5th Cir. 1972); *accord*, United States v. Cheung, 485 F.2d 689 (5th Cir. 1973); United States *ex rel.* Russo v. Superior Court, 483 F.2d 7 (3d Cir.), *cert. denied*, 414 U.S. 1023 (1973); United States v. Tinney, 473 F.2d 1085 (3d Cir.), *cert. denied*, 412 U.S. 928 (1973); United States v. Lansdown, 460 F.2d 164 (4th Cir. 1972); *cf.* Houp v. Nebraska, 427 F.2d 254 (8th Cir. 1970), *cert. denied*, 401 U.S. 924 (1971).

[73]United States v. Walden, 448 F.2d 925 (4th Cir. 1971), *cert. denied*, 409 U.S. 867, *district court aff'd on rehearing by an equally divided court*, 458 F.2d 36 (4th Cir. 1972) (en banc), *cert. denied*, 410 U.S. 969 (1973).

[74]Illinois v. Somerville, 410 U.S. 458 (1973); United States v. Jorn, 400 U.S. 470 (1971); Downum v. United States, 372 U.S. 734 (1963); Gori v. United States, 367 U.S. 364 (1961); Perez v. United States, 22 U.S. (9 Wheat.) 579 (1824).

[75]22 U.S. (9 Wheat.) 579 (1824).

[76]"In view of these and other alternatives . . . we cannot say there was manifest necessity for the trial judge's actions." United States v. Dinitz, 492 F.2d 53, 61 (5th Cir. 1974); *accord*, United States v. Kwitek, 467 F.2d 1222 (7th Cir.), *cert. denied*, 409 U.S. 1079 (1972); *see* United States v. Cheung, 485 F.2d 689 (5th Cir. 1973); United States *ex rel.* Russo v. Superior Court, 483 F.2d 7 (3d Cir.), *cert. denied*, 414 U.S. 1023 (1973); McNeal v. Hollowell, 481 F.2d 1145 (5th Cir. 1973), *cert. denied*, 415 U.S. 951 (1974); United States v. Tinney, 473 F.2d 1085 (3d Cir.), *cert. denied*, 412 U.S. 928 (1973); Featherston v. Mitchell, 418 F.2d 582 (5th Cir. 1969), *cert. denied*, 397 U.S. 937 (1970); Price v. Slayton, 347 F. Supp. 1269 (W.D. Va. 1972); United States v. Clark, 346 F. Supp. 428 (E.D. Pa. 1972); United States *ex rel.* Peetros v. Rundle, 342 F. Supp. 55 (E.D. Pa.

less of whatever interruption occurred.[77] Therefore, the application of the doctrine becomes much more difficult than its definition.

A. During Trial

One primary consideration of a defense attorney is to preserve his client's right to assert double jeopardy should a mistrial be declared. Since a motion for mistrial may operate as a waiver of his client's right to plead double jeopardy,[78] he should refrain from so moving unless essential to the protection of other rights of his client. Once the mistrial motion has been made it is necessary to provide a fertile record for the subsequent double jeopardy claim. The judge should be requested to consider carefully the entire situation, and possible specific alternatives should be presented to him. Any possibility of prosecutorial manipulation should be revealed along with an explanation of intent to plead double jeopardy if the mistrial is granted. A record showing that the mistrial was declared despite these requests and revelations would be extremely potent on appeal.

The prosecutor should at all times be aware of his duty to preserve any mistrial for retrial. A defense motion for mistrial should precipitate a request by the prosecutor to the judge to warn the defendant that this motion will operate to waive his right to plead double jeopardy. He should not relent until the record reflects that the defendant knowingly waived his rights.[79] The prosecutor should vehemently object to mistrial if there appears to be any reasonable alternative or if the cause of the mistrial could be interpreted as lending itself to prosecutorial manipulation.[80] Even more important is the responsibility to take preventive measures to ensure that he is not the cause of the mistrial.

The trial judge should strive to make the record reflect his careful, reasoned consideration and rejection of any possible or suggested alternatives. When a defendant moves for mistrial, the judge should warn him that the motion will waive his right to plead former jeopardy; the judge should attempt to elicit express waiver as a condition of the motion. The judge should be cognizant of the strong improbability of a reviewing court allowing retrial if the mistrial is caused by a situation susceptible of prosecutorial manipulation.[81] In such a situation, there-

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1972), *aff'd*, 478 F.2d 1399 (3d Cir. 1973); United States v. LeMay, 330 F. Supp. 628 (D. Mont. 1971); *cf.* United States v. Moon, 491 F.2d 1047 (5th Cir. 1974); United States v. Lansdown, 460 F.2d 164 (4th Cir. 1972); Houp v. Nebraska, 427 F.2d 254 (8th Cir. 1970), *cert. denied*, 401 U.S. 924 (1971).

[77] *E.g.*, United States v. Dinitz, 492 F.2d 53 (5th Cir. 1974).

[78] *See* notes 37 through 39 and accompanying text *supra*.

[79] *See* notes 42 through 46 and accompanying text *supra*.

[80] *See* note 65 and accompanying text *supra*.

[81] *Id.*

fore, he should strenuously attempt to salvage the instant trial.

B. On Review

It is first necessary for defense counsel to dispose of any waiver problems. If the defendant made the motion, the attorney must marshal facts to show that the motion was not a knowledgeable waiver,[82] or that there existed "prosecutorial overreaching."[83] Next, counsel must deal with the presumptions. If the situation which created the need for the mistrial raises a presumption that a manifest necessity existed (such as a hung jury,[84] contaminated juror[85] or other neutral cause[86]), counsel should first try to reverse the presumption by presenting evidence to show that either prosecutorial or judicial manipulation could have been involved. Counsel should then try to show that alternatives to the mistrial were available which the trial judge refused to consider.

On appeal, the government should endeavor to show that the defendant knowingly waived his right to appeal by not pleading double jeopardy at his subsequent retrial,[87] by making the motion for mistrial,[88] or by creating the circumstances which necessitated the retrial.[89] The state must then direct the evidence toward a showing that there was no prosecutorial manipulation or judicial overreaching involved as either a cause or result of the mistrial.[90] Next, the state should attempt to show that the judge considered every alternative to mistrial and that no reasonable one existed.[91] Upon failure to prove either waiver or the complete absence of prosecutorial manipulation and judicial overreaching, the state must attempt to prove that there was no possible alternative to the mistrial. Since continuing the trial is usually appropriate in these circumstances, this burden is almost impossible to meet.[92]

The reviewing court must first determine waiver questions. The

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[82]*See* notes 42 through 46 and accompanying text *supra*.

[83]*See* notes 48 through 50 and accompanying text *supra*.

[84]*See* notes 55 through 58 and accompanying text *supra*.

[85]*See* notes 59 through 62 and accompanying text *supra*.

[86]*See* notes 63 & 64 and accompanying text *supra*.

[87]*See* notes 34 through 36 and accompanying text *supra*.

[88]*See* notes 37 through 50 and accompanying text *supra*.

[89]*See* notes 51 through 54 and accompanying text *supra*.

[90]The state will be aided in this task by Somerville v. United States, 410 U.S. 458 (1973), which indicated an attitude that the courts should not be overly suspicious about prosecutorial manipulation. This opinion perhaps requires that more than a possibility of manipulation must be shown before the presumption barring retrial will arise. For a list of various indicators of prosecutorial manipulation, see notes 66 through 69 and accompanying text *supra*.

[91]*See* note 76 *supra*.

[92]*See* notes 65 & 72 and accompanying text *supra*.

trend is away from the pro forma strict rules; the appellate court examines the entire record to determine if there was an intentional waiver of a known right.[93] Once this determination has been made, the court must examine alternatives to the mistrial to determine if a less drastic measure would have sufficed. The court should be influenced by evidence of the length and the quality of the consideration the judge gave to possible alternatves.[94] If a reasonable alternative can be found, then there exited no manifest necessity for the mistrial and retrial should be barred.[95] If no alternative existed, however, the court must rely on the presumptions which swell from the facts. If the need for the mistrial was created by a hung jury,[96] juror contamination,[97] or by another neutral cause,[98] the presumption runs against the defendant. He must bear the burden of proving there existed an alternative to the mistrial or suffer retrial. If the cause of the mistrial is one susceptible of prosecutorial or judicial misuse, the presumption is in the defendant's favor.[99] Unless the prosecution can meet the almost impossible burden of proving that no alternative, including continuing the original trial, existed, the defendant should be set free.

CONCLUSION

It must be recognized that these categories of cases are not and cannot be clearly and strictly defined. Their purpose is only to provide a tool to enable one to grasp how the various waiver and presumption concepts operate. The courts have too long shied away from giving practical substantive meaning to the obscure definition of manifest necessity. Opinions addressing the realities and complexities of waiver and of the presumptions are just beginning to appear;[100] many more are needed.

Thomas C. Collier, Jr.
Melvin Hurley McFatter

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[93]*See* notes 42 through 47 and accompanying text *supra*.

[94]*See, e.g.*, United States v. Clark, 346 F. Supp. 428 (E.D. Pa. 1972).

[95]*See* note 75 *supra*.

[96]*See* notes 55 through 58 and accompanying text *supra*.

[97]*See* notes 59 through 62 and accompanying text *supra*.

[98]*See* notes 63 & 64 and accompanying text *supra*.

[99]*See* notes 65 through 73 and accompanying text *supra*.

[100]*See, e.g.*, United States v. Dinitz, 492 F.2d 53 (5th Cir. 1974); McNeal v. Hollowell, 481 F.2d 1145 (5th Cir. 1973), *cert. denied*, 415 U.S. 951 (1974); United States v. Walden, 448 F.2d 925 (4th Cir. 1971), *cert. denied*, 409 U.S. 867, *district court aff'd on rehearing by an equally divided court*, 458 F.2d 36 (4th Cir. 1972) (en banc), *cert. denied*, 410 U.S. 969 (1973).

RECENT DECISIONS

TORTS—PRODUCTS LIABILITY—MANUFACTURER OF A DEFECTIVE PRODUCT MAY BE HELD STRICTLY LIABLE IN TORT DESPITE FORESEEABLE INTERVENING NEGLIGENCE WITHIN THE DISTRIBUTIVE CHAIN

Plaintiff brought a products liability suit in a wrongful death action against the defendant manufacturer for the death of her husband, who was run over by his tractor when it started in gear.[1] The tractor, manufactured by the defendant in 1965, was equipped with a "starter safety switch," specifically designed to prevent starting while in gear. The following year the defendant notified its dealers of a possibly defective safety switch[2] in the model sold secondhand to plaintiff's decedent in 1970.[3] The dealer[4] neither inspected nor attempted to repair the switch, nor was the decedent warned of the possible defect. The plaintiff contended that the manufacturer was strictly liable in tort for placing the tractor on the market in a defective condition which made it unreasonably dangerous for its intended use.[5] The manufacturer argued that the dealer's negligent omission was the proximate cause of the accident,[6] and that the decedent's starting the tractor in gear while standing on the ground constituted misuse,[7] which relieved the defendant of liability for the original defect. The circuit court, sitting without a jury, applied Section 402A of the *Restatement (Second) of Torts*,[8] and found the defendant manufacturer strictly liable in tort.

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[1]The plaintiff, administratrix of her deceased husband's estate, brought suit in behalf of the estate pursuant to Mississippi's wrongful death statute, MISS. CODE ANN. § 11-7-13 (1972), *construed in* Thornton v. Insurance Co. of N. America, 287 So. 2d 262 (Miss. 1973). *See* Maraist & Barksdale, *Mississippi Products Liability—A Critical Analysis*, 43 MISS. L.J. 139, 190 (1972). For a comprehensive study of damages under Mississippi's version of Lord Campbell's Act, see Luckett & Thomas, *Wrongful Death Damages in Mississippi*, 43 MISS. L.J. 633 (1972).

[2]In response to reports that some of its tractors were starting in gear, the defendant recommended in a service bulletin sent to its dealers that a shorter plunger and dowel bolt be installed in the starter safety-switch system to alleviate any danger. Ford Motor Co. v. Matthews, 291 So. 2d 169, 172 (Miss. 1974).

[3]The tractor was damaged by fire in 1968. The dealer purchased the salvage, and mechanics trained by the defendant rebuilt the tractor using only "Ford" parts, but since the plunger had not been damaged, it was not replaced. *Id.* at 171.

[4]A settlement was reached between the plaintiff and the dealer during the trial in the Circuit Court of Benton County, Mississippi, leaving Ford Motor Co. the sole defendant. *Id.* at 170.

[5]*See* notes 27 & 28 *infra*. For an excellent historical discussion of the application of strict liability in tort in Mississippi, see State Stove Mfg. Co. v. Hodges, 189 So. 2d 113 (Miss. 1966), *cert. denied*, 386 U.S. 912 (1967); Maraist & Barksdale, *supra* note 1.

[6]Whether recovery is sought under strict liability in tort, negligence, or warranty, the plaintiff is required to establish that the defective product was the proximate cause of the injury. W. PROSSER, THE LAW OF TORTS § 103, at 671-72 (4th ed. 1971) [hereinafter cited as PROSSER]; *see* Denman v. Armour Pharmaceutical Co., 322 F. Supp. 1370, 1375 (N.D. Miss. 1970).

[7]Misuse, abnormal or unforeseeable use of a product is recognized as a defense to strict tort liability. *See* note 32 *infra*.

[8]*Special Liability of Seller of Products for Physical Harm to User or Consumer:*

On appeal to the Mississippi Supreme Court, *held*, affirmed. The manufacturer of a defective and unreasonably dangerous product which reaches the ultimate consumer without substantial change in its condition will not be relieved of liability under the doctrine of strict liability in tort by the foreseeable failure of a retailer to remedy the defect or the purchaser's contributory negligence in failing to guard against its existence. *Ford Motor Co. v. Matthews*, 291 So. 2d 169 (Miss. 1974).

Products liability is a branch of the law defining the tort liability of manufacturers and other sellers of chattels to third persons whether or not a contractual relationship exists.[9] The doctrine has evolved from 19th century case law concerning the liability of contracting parties to third persons other than assignees or third-party beneficiaries. The leading case, *Winterbottom v. Wright*,[10] held that the driver of a mailcoach, who was injured when it collapsed, could not maintain a cause of action on the breach of contract to keep the coach in good repair.[11] Although the case was founded on contract principles, the general rule that a contracting party will not be held liable in contract or tort to a third person not in privity with the transaction became embedded in the law of England and the United States.[12] Originating in New York, a series of later decisions developed exceptions to the privity requirement, especially where the product was intended for human consumption.[13] A turning point came in 1916

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(1) One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property, if

(a) the seller is engaged in the business of selling such a product, and

(b) it is expected to and does reach the user or consumer without substantial change in the condition in which it is sold.

RESTATEMENT (SECOND) OF TORTS § 402A (1965).

[9]*Compare* PROSSER § 96, at 641, *with* Maraist & Barksdale, *supra* note 1, at 140.

[10]152 Eng. Rep. 402 (Ex. 1842).

[11]Lord Abinger said:

[H]ere the action is brought simply because the defendant was a contractor with a third person; and it is contended that thereupon he became liable to everyone who might use the carriage . . . . There is no privity of contract between these parties; and if the plaintiff can sue, every passenger, or even any person passing along the road, who was injured by the upsetting of the coach, might bring a similar action. Unless we confine the operation of such contracts as this to the parties who entered into them, the most absurd and outrageous consequences to which I see no limit, would ensue.

Id. at 404-05.

[12]For an analysis of this period, see Prosser, *The Assault Upon the Citadel*, 69 YALE L.J. 1099 (1960).

[13]Thomas v. Winchester, 6 N.Y. 397, 57 Am. Dec. 455 (1852). In *Thomas*, the husband's death was attributed to drugs which his wife purchased from a local druggist. In a suit brought against the druggist, the absence of privity was raised as a defense. The court held the druggist liable for negligence regardless of privity, since his conduct placed human life in "imminent danger." *Id.* at 409, 57 Am. Dec. at 459; *see, e.g.*, Huset v. J.I. Threshing Mach. Co., 120 F. 865 (8th Cir. 1903); Mazetti v. Armour & Co., 75 Wash. 622, 135 P. 633 (1913); E. HARPER & F. JAMES, TORTS § 18.5 (1956); PROSSER § 96, at 642. *Compare* Liggett & Myers Tobacco Co. v. Cannon, 132 Tenn. 419, 178 S.W. 1009 (1915), *with* Pillars v. R.J. Reynolds Tobacco Co., 117 Miss. 490, 78 So. 365 (1918).

with *MacPherson v. Buick Motor Co.*[14] In *MacPherson*, the court expanded the existing exceptions to the privity requirement to include all products which would subject the consumer to a risk of harm if negligently manufactured. The decision imposed a duty on a manufacturer to exercise reasonable care in producing a reasonably safe product.[15] Although the *MacPherson* rule was immediately accepted in the majority of jurisdictions,[16] Mississippi rejected it and continued to require privity of contract[17] unless food or drug products were involved.[18] Since recovery based on negligence produced inadequate remedies for many plaintiffs due to the complexities of proof and the defense of contributory negligence,[19] the courts sought to make the duty imposed by *MacPherson* more absolute. Again the common law of contracts was the source for a cause of action

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[14]217 N.Y. 382, 111 N.E. 1050 (1916). The manufacturer of an automobile with a defective wheel was held liable for negligence although no contractual relationship existed between the manufacturer and the plaintiff, who had purchased the automobile from a retail dealer. The court said:

> If the nature of a thing is such that it is reasonably certain to place life and limb in peril when negligently made, it is then a thing of danger . . . . If to the element of danger there is added knowledge that the thing will be used . . . without new tests, then irrespective of contract, the manufacturer of this thing of danger is under a duty to make it carefully.

Id. at 389, 111 N.E. at 1053.

[15]*MacPherson* has been interpreted in different ways. A seller is liable for negligence in the manufacture, design, or sale of any product which may reasonably be expected to be capable of inflicting substantial harm if it is negligently made. PROSSER § 96, at 643. A seller is liable for negligence if he fails to exercise reasonable care in placing the product on the market for consumption. Wade, *Strict Tort Liability for Manufacturers*, 19 Sw. L.J. 5, 15 (1965).

[16]*See* State Stove Mfg. Co. v. Hodges, 189 So. 2d 113, 116 (Miss. 1966), *cert. denied*, 386 U.S. 912 (1967); Prosser, *supra* note 12, at 1100.

[17]Ford Motor Co. v. Myers, 151 Miss. 73, 117 So. 362 (1928), *overruled*, State Stove Mfg. Co. v. Hodges, 189 So. 2d 113 (Miss. 1966), *cert. denied*, 386 U.S. 912 (1967). In *Ford*, the court held that since privity of contract was lacking, a cause of action could not be maintained against the manufacturer of a defective truck which caused the death of the owner, who had purchased it from a local dealer.

[18]*See* Cox v. Laws, 244 Miss. 696, 145 So. 2d 703 (1962) (drugs); Cone v. Virginia-Carolina Chem. Corp., 178 Miss. 816, 174 So. 554 (1937) (chemical in fertilizer); Swift & Co. v. Hawkins, 174 Miss. 253, 164 So. 231 (1935) (cheese); Pillars v. R.J. Reynolds Tobacco Co., 117 Miss. 490, 78 So. 365 (1918) (chewing tobacco). *But see* Elmore v. Grenada Groc. Co., 189 Miss. 370, 197 So. 761 (1940); Kroger Groc. Co. v. Lewelling, 165 Miss. 71, 145 So. 726 (1933), cases in which retailers escaped liability as mere conduits for products purchased in sealed containers from the manufacturer. Beginning in 1957, the federal courts concluded that Mississippi would follow the *MacPherson* logic: Mason v. American Emery Wheel Works, 241 F.2d 906 (1st Cir. 1957) (applying Mississippi law); *accord*, Necaise v. Chrysler Corp., 335 F.2d 562 (5th Cir. 1964); Grey v. Hayes-Samons Chem. Co., 310 F.2d 291 (5th Cir. 1962). *But see* Harrist v. Spencer-Harris Tool Co., 244 Miss. 84, 140 So. 2d 558 (1962), utilizing the antiquated "inherently dangerous" exception to the privity requirement in contradicting the prediction of the federal courts.

[19]Prosser, *supra* note 12, at 1116; *see* RESTATEMENT (SECOND) OF TORTS §§ 463-67, at 506-16 (1965).

imposing liability on the manufacturer of defective products—strict liability in warranty. Negligence imposes liability based on fault. Strict liability in warranty is predicated upon a showing that the product did not conform to the express or implied representations of the manufacturer as to its safety, regardless of fault. The leading strict liability in warranty case, *Baxter v. Ford Motor Co.*,[20] was preempted by a Mississippi decision which imposed strict liability on a manufacturer for breach of an implied warranty of fitness.[21] With the advent of the Uniform Commercial Code, recovery by an aggrieved consumer against a seller of a defective product was provided by statute.[22] Strict liability in warranty, limited by contract principles,[23] proved unsatisfactory as a mode of tort recovery for defective products[24] despite the elimination of the requirements of showing negligence or privity.[25] Section 402A of the *Restatement (Second) of Torts* proposed an alternative to recovery on the negligence or warranty theories.[26] Strict liability in tort would be imposed if the product was both "defective"[27] and "unreasonably dangerous"[28] regardless of the care exercised by the

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[20]168 Wash. 456, 12 P.2d 409, *aff'd on rehearing*, 15 P.2d 1118 (1932), *on second appeal aff'd*, 179 Wash. 123, 35 P.2d 1090 (1934). A manufacturer of automobiles, who had represented the windshield as shatterproof in sales literature, was held strictly liable to a purchaser who was blinded when a pebble shattered the windshield. *See* 2 L. FRUMER & M. FRIEDMAN, PRODUCTS LIABILITY § 16.04(4), at 3-228 (1970) [hereinafter cited as FRUMER]; PROSSER § 97, at 651-52.

[21]Coca-Cola Bottling Works v. Lyons, 145 Miss. 876, 111 So. 305 (1927). The court held the manufacturer strictly liable for injuries caused by glass in a beverage bottle, theorizing an implied warranty of fitness running with the goods to avoid the privity requirement. *Accord*, Coca-Cola Bottling Works v. Simpson, 158 Miss. 390, 130 So. 479 (1930); *see* State Stove Mfg. Co. v. Hodges, 189 So. 2d 113, 117-19 (Miss. 1966), *cert. denied*, 386 U.S. 912 (1967).

[22]MISS. CODE ANN. §§ 75-2-313 to -318 (1972). Mississippi adopted the Uniform Commercial Code in 1966.

[23]*See* MISS. CODE ANN. § 75-2-607 (1972), which requires the buyer to give the seller notice of the breach of warranty in order to perfect his strict liability claim; UNIFORM COMMERCIAL CODE § 2-316 (not adopted in Mississippi), which allows the seller to defeat liability through disclaimer; Note, *Commercial Law—Disclaimer of Warranties Under the Uniform Commercial Code*, 40 MISS. L.J. 310 (1969).

[24]General adherence to contract principles in the application of strict liability in warranty caused the courts to look for a contract, thus subtly involving privity. *See* Maraist & Barksdale, *supra* note 1, at 152-58.

[25]Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 161 A.2d 69 (1960). In *Henningsen*, the plaintiff was injured in an automobile accident caused by a faulty steering gear. The court held both the dealer and the manufacturer liable for breach of an implied warranty of safety without a showing of negligence or privity. *See* Prosser, *The Fall of the Citadel*, 50 MINN. L. REV. 791 (1965).

[26]*See* note 8 *supra*.

[27]For a discussion of what constitutes a defective product, see RESTATEMENT (SECOND) OF TORTS § 402A, comments *g* & *h* at 351-52 (1965). *See* State Stove Mfg. Co. v. Hodges, 189 So. 2d 113, 121 (Miss. 1966), *cert. denied*, 386 U.S. 912 (1967) ("the article has something wrong with it"); PROSSER § 99, at 659 ("the product does not meet the reasonable expectations of the ordinary consumer as to its safety").

[28]For a discussion of what constitutes an unreasonably dangerous product, see RESTATEMENT (SECOND) OF TORTS § 402A, comment *i* at 352 (1965).

seller or the existence of privity.[29] Justification for this position is founded upon policy demands that the risk of injury arising from defective products should be placed on the party best able to abate the risk or, in the alternative, absorb the loss.[30] Under this doctrine, the plaintiff's burden of proof is satisfied upon a showing that: (1) the plaintiff was injured by the product; (2) the injury occurred because the product was defective; (3) the defect existed when the product left the manufacturer's control; and (4) the product was used as it was intended.[31] Conduct on the part of the purchaser or intermediate party may give rise to the defenses to strict tort liability of product misuse[32] and assumption of risk.[33] Contributory negligence encompasses varying forms of intervening mis-

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[29]Whether a product is defective and unreasonably dangerous is determined by considering the following factors: (1) the usefulness and desirability of the product—its social utility; (2) the likelihood of injury and its probable seriousness; (3) the availability of safer products which perform the same function; (4) the ability of the manufacturer to eliminate the product's dangerous propensities without seriously impairing the product's usefulness or making it unduly expensive; (5) the avoidability of injury through the exercise of ordinary care in the product's use by the consumer; and (6) the obviousness of the defect. *See* Wade, *On the Nature of Strict Tort Liability for Products,* 44 MISS. L.J. 825, 837 (1973); Wade, *supra* note 15 at 17.

The *Restatement* requirements of "defective" and "unreasonably dangerous" are neither readily definable nor mutually exclusive. When a plaintiff is injured by an allegedly defective product, the presumption that the product is also unreasonably dangerous arises. Recent cases have recognized when an injury is caused by a defectively designed product the defective and unreasonably dangerous criteria merge, and the plaintiff's burden of proof is satisfied solely upon a showing that the product was defective. Cronin v. J.B.E. Olson Corp., 8 Cal. 3d 121, 501 P.2d 1153, 104 Cal. Rptr. 433 (1972), *noted in* 23 DRAKE L. REV. 197 (1973); 42 FORDHAM L. REV. 943 (1974); 49 WASH. L. REV. 231 (1973); *accord,* Glass v. Ford Motor Co., 123 N.J. Super. 599, 304 A.2d 562 (L. Div. 1973), *noted in* 42 FORDHAM L. REV. 943 (1974); 5 SETON HALL L. REV. 152 (1973). *Contra,* Brown v. Western Farmers Ass'n, 521 P.2d 537 (Ore. 1974).

[30]RESTATEMENT (SECOND) OF TORTS § 402A, comment *c* at 349-50 (1965); *see* Chance v. E.I. DuPont de Nemours & Co., 345 F. Supp. 353, 368-70 (E.D.N.Y. 1972); Prosser, *supra* note 25, at 799-800.

[31]The plaintiff must establish that the product was not reasonably safe for its intended use, and that the defective condition was the proximate cause of the injury. The proximate cause question in any products liability action is whether it was foreseeable that the particular harm suffered by the plaintiff would result from use of the product. This is a question of *fact* for the trier of fact, distinguishing strict liability in tort from strict liability for ultrahazardous activities. See Rylands v. Fletcher, L.R. 1 Ex. 265 (1866), *aff'd,* L.R. 3 H.L. 399 (1868), where liability is imposed by the court as a matter of law. Wade, *supra* note 29, at 835-37.

[32]*See* PROSSER § 103, at 671-76. A product is not regarded as defective and unreasonably dangerous when the injury results from abnormal use not reasonably foreseeable by the manufacturer. Noel, *Defective Products: Abnormal Use, Contributory Negligence, and Assumption of Risk,* 25 VAND. L. REV. 93, 95-105 (1972); *see* PROSSER § 102, at 667-70.

[33]Assumption of risk is defined as a willingness or consent, express or implied, by the plaintiff to use a product he knows is defective and unreasonably dangerous. The plaintiff knows, understands, and voluntarily incurs the risk. Noel, *supra* note 32, at 119-28; *see* FRUMER § 16A(5)(f), at 3-351 to -364.

conduct. In the form of failing to discover and remedy a latent defect or guard against its existence, contributory negligence is no defense to strict liability in tort.[34] The defense is available, however, when the plaintiff's negligent conduct involves misuse or approaches assumption of risk, as when he voluntarily uses a known defective and unreasonably dangerous product.[35] The first application of the doctrine of strict liability in tort was in *Greenman v. Yuba Power Products, Inc.*[36] Three years later, Mississippi, which had refused to accept the *MacPherson* logic of recovery in negligence without privity, adopted strict liability in tort in *State Stove Manufacturing Co. v. Hodges.*[37] The court decided that a manufacturer or other seller would be held strictly liable in tort if: (1) a defective product which is unreasonably dangerous to the consumer is placed upon the market; (2) the plaintiff's harm resulted from the defective product; (3) the product was used as intended; (4) the manufacturer or seller was engaged in the business of selling such a product; and (5) the product was expected to, and did, reach the ultimate consumer without substantial change in its condition.[38] In the disposition of the case, however, the court reverted to negligence considerations in holding that the intervening negligence of the retailer was the proximate cause of the accident, and summarily relieved the manufacturer of all liability.[39] The dissent, in asserting the substantive policy considerations of

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[34]*See* RESTATEMENT (SECOND) OF TORTS § 402A, comment *n* at 356 (1965); Noel, *supra* note 32, at 105-19.

[35]Early-Gary, Inc. v. Walters, 294 So. 2d 181, 186 (Miss. 1974); *see* RESTATEMENT (SECOND) OF TORTS § 402A, comment *n* at 356 (1965); FRUMER § 16A(5) (f), at 3-351 to -364; PROSSER § 102, at 670-71.

[36]59 Cal. 2d 57, 377 P.2d 897, 27 Cal. Rptr. 697 (1963). *But see* Cronin v. J.B.E. Olson Corp., 8 Cal. 3d 121, 501 P.2d 1153, 104 Cal. Rptr. 433 (1972); Wade, *On the Nature of Strict Tort Liability for Products*, *supra* note 29, at 829-41.

[37]189 So. 2d 113 (Miss. 1966) *cert. denied,* 386 U.S. 912 (1967), *overruling*, Ford Motor Co. v. Myers, 151 Miss. 73, 117 So. 362 (1928); *see* note 17 *supra*. The plaintiff sued the manufacturer of a hot water heater and the contractors who were responsible for installing it for damages when it exploded and destroyed the plaintiff's house. The court held, however, that strict tort liability would not attach to the manufacturer since the product was not in a defective, unreasonably dangerous condition when it left the control of the manufacturer (although the thermostats failed to work). The court viewed the negligent failure of the contractors to follow the manufacturer's installation instructions as the proximate cause of the accident, relieving the manufacturer of all liability. Furthermore, the court stated that the product, once it had undergone the process of installation, was not in substantially the same condition as it was when it was manufactured. *Compare* State Stove Mfg. Co. v. Hodges, 189 So. 2d 113 (Miss. 1966), *cert. denied*, 386 U.S. 912 (1967), *with* Suvada v. White Motor Co., 32 Ill. 2d 612, 210 N.E.2d 182 (1965) (where Illinois adopted *Restatement 2d* § 402A strict tort liability).

[38]189 So. 2d at 118, 121; *see* Dunham v. Vaughn & Bushnell Mfg. Co., 42 Ill. 2d 339, 247 N.E.2d 401 (1969); Maraist & Barksdale, *supra* note 1, at 149-52.

[39]189 So. 2d at 123, *citing* E.I. DuPont de Nemours & Co. v. Ladner, 221 Miss. 378, 73 So. 2d 249 (1954); Ford Motor Co. v. Wagoner, 183 Tenn. 392, 192 S.W.2d 840 (1946). Both courts absolved the manufacturer of defective products because the manufacturer had done everything reasonably possible to remedy the danger or defect. *Accord*, Nishidi v. E.I. DuPont de Nemours & Co., 245 F.2d 768 (5th Cir. 1957); General Motors Corp. v. Jenkins, 114 Ga. App. 873, 152 S.E.2d 796 (1966); Rekab, Inc. v. Frank Hrubetz & Co.,

the *Restatement*, which the court purportedly adopted, distinguished the case law relied upon by the majority in allowing the negligence of the intermediate retailer to supersede the imposition of strict liability in tort upon the manufacturer.[40] This innocent commingling of negligence with strict liability in tort principles has caused confusion in the application of strict products liability during the 8 years since the advent of *State Stove*.[41] Although the courts have rigorously applied the prerequisites to strict liability in tort, some cases have succeeded in holding the manufacturer strictly liable,[42] while others have required a showing of negligence on the part of the manufacturer in addition to the *State Stove* provisions before imposing liability.[43] Only the most recent decisions have portrayed a substance-over-form application of the doctrine of strict tort liability.[44]

In the instant case, the court applied the prerequisites to liability of section 402A of the *Restatement* as adopted in *State Stove*, and concluded that since there was substantial evidence that a defect in the design of the safety-switch system rendered the tractor unreasonably dangerous, and since the defective plunger reached the ultimate purchaser in its original form without substantial change in its condition, the defect was the proximate cause of the injury, and the manufacturer was to be held strictly liable in tort. As to the defendant's contention that the intervening negligence of the dealer should supersede the manufacturer's ultimate responsibility for the plaintiff's damages, the court postulated that the range of foreseeability is directly proportional to the degree

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261 Md. 141, 274 A.2d 107 (1971). *Contra*, State Stove Mfg. Co. v. Hodges, 189 So. 2d 113, 125-28 (Miss. 1966) (dissenting opinion), *citing* Vandermark v. Ford Motor Co., 61 Cal. 2d 256, 391 P.2d 168, 37 Cal. Rptr. 896 (1964); *see* RESTATEMENT (SECOND) OF TORTS §§ 400, 402A, comment *f* at 337, 350 (1965).

[40]189 So. 2d at 127, *distinguishing* E.I. DuPont de Nemours & Co. v. Ladner, 221 Miss. 378, 73 So. 2d 249 (1954); *see* note 39 *supra* and text accompanying notes 47-49 *infra*.

[41]*See* Maraist & Barksdale, *supra* note 1, at 150-51; Wade, *The New Liability for Products*, in TORTS TRENDS 13-15 (Mississippi Law Institute 1971).

[42]*See* Bohannon v. Chrysler Motor Corp., 366 F. Supp. 802 (S.D. Miss. 1973) (manufacturer solely liable); Breedlove v. Beech Aircraft Corp., 334 F. Supp. 1361 (N.D. Miss. 1971); Falstaff Brewing Corp. v. Williams, 234 So. 2d 620 (Miss. 1970) (distributor liable); Ford Motor Co. v. Dees, 223 So. 2d 638 (Miss. 1969) (manufacturer solely liable); Ford Motor Co. v. Cockrell, 211 So. 2d 833 (Miss. 1969) (manufacturer solely liable).

[43]*E.g.*, Sam Shainberg Co. v. Barlow, 258 So. 2d 242 (Miss. 1972) (indistinguishable on the facts from *Falstaff Brewing), criticized in* FRUMER § 19A, at 5-224 to -227; *see* Ward v. Hobart Mfg. Co., 450 F.2d 1176 (5th Cir. 1971), *rev'g* 317 F. Supp. 841 (S.D. Miss. 1970); Pridgett v. Jackson Iron & Metal Co., 253 So. 2d 837 (Miss. 1971) (confusing policy determinations contrary to *Restatement* 2d § 402A); *cf.* General Motors Corp. v. Howard, 244 So. 2d 726 (Miss. 1971); Ford Motor Co. v. Simpson, 233 So. 2d 797 (Miss. 1970) (second collision doctrine); Walton v. Chrysler Motor Corp., 229 So. 2d 568 (Miss. 1970) (associating *State Stove* strict tort liability prerequisites with a finding of duty and breach). *Contra*, Larsen v. General Motors Corp., 391 F.2d 495 (8th Cir. 1968); Mickle v. Blackmon, 252 S.C. 202, 166 S.E.2d 173 (1969).

[44]*See* Early-Gary, Inc. v. Walters, 294 So. 2d 181 (Miss. 1974); Hamilton Fixture Co. v. Anderson, 285 So. 2d 744, 747 (Miss. 1973) ("'[A]ll possible care,' is not vital to . . . a cause of action in strict liability in tort in the sense that there is *no need to prove the manufacturer was negligent.*") (emphasis added).

of danger involved. According to the court, the question of liability is determined by whether the manufacturer should have reasonably foreseen the possibility that the dealer's neglect would frustrate the manufacturer's corrective efforts. Since the tractor in its originally defective condition was potentially capable of inflicting serious injury upon the user, the court declared that the manufacturer would not be relieved of liability as it was reasonably foreseeable that the dealer would not be responsive to a single warning in a service bulletin. As to the defendant's allegation of product misuse, the court determined that since the possibility that an operator might carelessly start the tractor in gear was foreseeable, the decedent's conduct was not misuse. The court characterized the decedent's actions as contributory negligence consisting of use for a proper purpose but in a careless manner, which is insufficient as a defense to strict liability in tort.[45] The court, emphasizing the *Restatement's* inherent policy that the burden for injuries caused by defective products should be borne by the manufacturer, concluded that contributory negligence and foreseeable negligent conduct within the distributive chain would be no bar to preserving the manufacturer's liability.

In *State Stove* and subsequent decisions, the court recognized that injuries derived from the intended use of defective, unreasonably dangerous products evoked the doctrine of strict liability in tort.[46] The conduct of intermediate parties in the distributive chain, however, often controlled whether liability would be imposed on the manufacturer.[47] A close examination of the instant decision indicates a tendency to mirror the approach of the application of strict tort liability expressed by the dissent in *State Stove*. The instant court distinguished *State Stove* by foreclosing the use of contributory negligence and foreseeable intervening negligence as defenses to the manufacturer's liability for an originally defective product.[48] The *State Stove* court, in concluding that the negligence of the retailer was the proximate cause of the explosion, intimated that the manufacturer's ultimate responsibility for a defective and unreasonably dangerous product could be delegable to a retailer or other intermediary. The instant case holds that when an originally defective product presents an unreasonable risk of harm to the ultimate user or consumer, the manufacturer incurs a nondelegable duty to remedy the defect. This position is not without precedent;[49] moreover, it is precisely the conclusion reached in the dissenting opinion

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[45]The court adopted the majority position. *See* text accompanying note 34 *supra*.

[46]*See* notes 42 & 44 *supra*.

[47]*See* note 43 *supra*.

[48]Ford Motor Co. v. Matthews, 291 So. 2d 169, 175-76 (Miss. 1974), in which the court distinguished both State Stove Mfg. Co. v. Hodges, 189 So.2d 113 (Miss. 1966), *cert. denied*, 386 U.S. 912 (1967), and E.I. DuPont de Nemours & Co. v. Ladner, 221 Miss. 378, 73 So. 2d 249 (1954); *see* Ford Motor Co. v. Wagoner, 183 Tenn. 392, 192 S.W.2d 840 (1946) (strict liability in tort was not available to plaintiffs). *See also* note 39 *supra*.

[49]*E.g.*, Williams v. Brown Mfg. Co., 45 Ill. 2d 418, 261 N.E.2d 305 (1970); Bexiga v. Havir Mfg. Corp., 60 N.J. 402, 290 A.2d 281 (1972). In Vandermark v. Ford Motor Co., 61 Cal. 2d 256, 391 P.2d 168, 37 Cal. Rptr. 896 (1964), the court stated:

> [S]ince Ford, as the manufacturer of a completed product, cannot delegate its duty to have its cars delivered to the ultimate purchaser free from dangerous

of *State Stove*.[50] Analyzing the congruence between the instant case and the late Chief Justice Ethridge's dissent, it is submitted that *State Stove* is no longer a current standard for the application of section 402A of the *Restatement (Second) of Torts* in Mississippi when the defect rendering the product unreasonably dangerous originates with the manufacturer.

The application of strict liability in tort for defective products involves the balancing of two competing policy considerations: (1) the position of the manufacturer in relation to his products is not that of an insurer, and (2) the policy of the *Restatement* requiring that the burden of liability for injuries attendant with defective, unreasonably dangerous products be placed on the manufacturer. The instant case reached a desirable equilibrium in this balancing approach. If the balance is to be maintained, the instant case must not be interpreted to relegate the conduct of intermediate parties in the distributive chain to an irrelevant position. Such a view would pronounce the manufacturer an insurer, and would lead to the imposition of absolute liability without fault, disrupting the policy balance. Under the doctrine of strict liability in tort, the manufacturer is not required to market an absolutely safe product, only one which is not unduly dangerous.[51]

Although the instant court did not have the opportunity to reach the issue, the *Restatement* provides that strict liability in tort applies to the retailer or other intermediate party as well as the manufacturer.[52] When the prerequisites are met, however, the majority of Mississippi decisions have applied strict liability in tort only to the manufacturer.[53] Arguably, the court has been practicing judicial expediency in relieving party defendants from bringing subsequent suits for indemnity. In a recent decision, however, the result of such practice has disrupted the policy balance. In *Sam Shainberg Co. v. Barlow*,[54] since the court could not obtain in personam jurisdiction over the manufacturer,[55] the plaintiff, who sustained injuries in a fall caused by defective shoes, was denied recovery when the suit was dismissed against the retailer and the wholesaler.[56] In light of *Ford Motor Co. v. Matthews*,[57] which reflects a strong inclination to protect

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defects, it cannot escape liability on the ground that the defect in Vandermark's car may have been caused by something one of its authorized dealers did or failed to do.

Id. at 259, 391 P.2d at 171, 37 Cal. Rptr. at 899.

[50]It is not good law or sound judicial policy to permit a manufacturer to escape liability by delegating to an intermediary the duty to install safety devices to protect against defects and failures in the product . . . .

189 So.2d at 126.

[51]Wade, *supra* note 15, at 16-17.

[52]RESTATEMENT (SECOND) OF TORTS § 402A, comment *f* at 350-51 (1965).

[53]*See* note 42 *supra*.

[54]258 So. 2d 242 (Miss. 1972).

[55]*But see* MISS. CODE ANN. § 13-3-57 (1972), *construed in* Breedlove v. Beech Aircraft Corp., 334 F. Supp. 1361 (N.D. Miss. 1971); Smith v. Temco, Inc., 252 So.2d 212 (Miss. 1971).

[56]258 So. 2d 242 (Miss. 1972); *see* FRUMER § 19A, at 5-224 to -227.

[57]291 So.2d 169 (Miss. 1974).

consumers injured by defective products, the task now facing the courts is to define the applicability of strict liability in tort to the individual members of the distributive chain.

William Norman Krucks

CONSTITUTIONAL LAW—EIGHTH AMENDMENT—STATUTORY PENALTY FOR POSSESSION OF MARIJUANA VIOLATES CRUEL AND UNUSUAL PUNISHMENTS CLAUSE

Defendants,[1] charged in the Superior Court of the District of Columbia with possession of marijuana, moved to dismiss, challenging the constitutionality of the statutory provision under which they were accused.[2] Defendants contended, *inter alia*, that the punishment prescribed for possession of marijuana, that is, a fine of not less than $100 nor more than $1,000, or imprisonment for not more than 1 year, or both, was violative of the eighth amendment's guarantee against cruel and unusual punishments.[3] The government maintained that such a challenge could be made only after the imposition of a sentence. The Superior Court, *held*, motions to dismiss granted. A statutory fine of from $100 to $1,000, or a prison sentence of up to 1 year, or both, for possession of marijuana is so disproportionate to the gravity of the offense that it violates the cruel and unusual punishments clause of the eighth amendment. *United States v. Grady*, Crim. No. 46126-73 (D.C. Super. Ct., May 17, 1974), *rev'd sub nom. United States v. Thorne*, 43 U.S.L.W. 2070 (D.C. Cir., Aug. 7, 1974).[4]

The phrase "cruel and unusual punishments" first appeared in 1688 in the English Bill of Rights.[5] Six states[6] had adopted similar laws by 1791 when the

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[1]The individual cases of United States v. Grady, Crim. No. 46126-73 (D.C. Super. Ct., May 17, 1974), and United States v. Thorne, Crim. No. 41716-73 (D.C. Super. Ct., May 17, 1974), were consolidated for purposes of motions.

[2]The court found the following statutes applicable: " 'Narcotic drugs' means coca leaves, opium, cannabis, isonipecaine, and opiate, and every substance not chemically distinguishable from them . . . ." D.C. CODE ANN. § 33-401(n) (1973). " 'Cannabis' includes . . . specifically . . . marijuana . . . as used in cigarettes or in any other articles . . . ." *Id.* § 33-401(m). "It shall be unlawful for any person to manufacture, possess, have under his control, sell, prescribe, administer, dispense or compound any narcotic drug except as authorized . . . ." *Id.* § 33-402(a). "Any person violating any provision of this chapter . . . shall upon conviction be [fined], . . . not less than $100 nor more than $1000, or . . . [imprisoned] for not exceeding one year, or both . . . ." *Id.* § 33-423.

[3]"Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted." U.S. CONST. amend. VIII.

[4]*Grady* is summarized in 15 Crim. L. Rptr. 2235 (D.C. Super. Ct., Aug. 12, 1974).

[5]For historical discussions of the cruel and unusual punishments principle, see Granucci, *"Nor Cruel and Unusual Punishments Inflicted": The Original Meaning*, 57 CALIF. L. REV. 839 (1969); Wheeler, *Toward a Theory of Limited Punishment: An Examination of the Eighth Amendment*, 24 STAN. L. REV. 838 (1972); Comment, *The Cruel and Unusual Punishment Clause and the Substantive Criminal Law*, 79 HARV. L. REV. 635 (1966); Note, *The Effectiveness of the Eighth Amendment: An Appraisal of Cruel and Unusual Punishment*, 36 N.Y.U.L. REV. 846 (1961).

[6]Maryland, Massachusetts, North Carolina, New Hampshire, Virginia, and Pennsylvania. Mosk, *The Eighth Amendment Rediscovered*, 1 LOYOLA (L.A.) L. REV. 4, 6-7 (1968).

wording of the English statute[7] was incorporated almost verbatim into the United States Constitution.[8] Early eighth amendment opinions construed the provision as merely a prohibition against torture, lingering death, and other inhuman and barbarous methods of punishment.[9] One of the first suggestions that the Supreme Court might extend the protection beyond such inherent cruelty came in *O'Neil v. Vermont*,[10] where the dissent stated: "The inhibition [of the eighth amendment] is directed . . . against all punishments which by their excessive length or severity are greatly disproportioned to the offenses charged."[11] This interpretation was embraced by a majority of the Court in 1910 in *Weems v. United States*.[12] Weems had been sentenced by a Philippine court[13] to 15 years at hard labor plus the permanent loss of certain civil rights[14] for the relatively minor offense of falsifying a public account book. Holding that even the minimum sentence provided by law would constitute cruel and unusual punishment, the Court ordered Weems freed. The Court stated: "[I]t is a precept of justice that the punishment for crime should be graduated and proportioned to the offense,"[15] and also reasoned that the eighth amendment "may . . . be progressive" and "may acquire meaning as public opinion becomes enlightened by a humane justice."[16] To determine disproportionality, the Court

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[7]"That excessive bail ought not to be required, nor excessive fines imposed; nor cruel and unusual punishments inflicted." SOURCES OF OUR LIBERTIES 247 (R. Perry ed. 1959), *citing* 1 W. & M., c. 2, § 10 (1689).

[8]An argument offered against the adoption of the eighth amendment by Congress was the assertion that its language was "too indefinite" and that "it seems to have no meaning in it." 1 ANNALS OF CONG. 754 (1789).

[9]*E.g.*, Howard v. Fleming, 191 U.S. 126 (1903); *In re* Kemmler, 136 U.S. 436 (1890); Wilkerson v. Utah, 99 U.S. 130 (1878).

[10]144 U.S. 323 (1892).

[11]*Id.* at 339-40 (Field, J., dissenting).

The idea of proportionality between crime and punishment was not an entirely novel one. Its legal origins in England can be traced at least as far back as the Magna Carta. "A free man shall not be amerced for a trivial offence, except in accordance with the degree of the offence; and for a serious offence he shall be amerced according to its gravity . . . ." Wheeler, *supra* note 5, at 853, *citing* J. HOLT, MAGNA CARTA 323 (1965). The proportionality concept can actually be traced to the time of Moses in the Old Testament. It has been suggested that the *lex talionis* of the Book of Exodus ("an eye for an eye, a tooth for a tooth") implies a maximum limit on penalties in relation to the seriousness of the wrong committed. Granucci, *supra* note 5, at 844.

[12]217 U.S. 349 (1910).

[13]The protection against cruel and unusual punishments which formed the basis for the *Weems* decision was a provision of the Philippine Bill of Rights. Since it was taken directly from the eighth amendment of the United States Constitution, however, it was deemed to have the same meaning. *Id.* at 367.

[14]The *cadena temporal*, the punishment to which Weems had been sentenced, provided in part, "They shall always carry a chain at the ankle, hanging from the wrists; they shall be employed at hard and painful labor . . . ." *Id.* at 364. This offensive and unconventional mode of punishment has led some writers to conclude that it was the type of punishment, not its disproportionality to the offense, which motivated the Court to invalidate Weems' sentence. Packer, *Making the Punishment Fit the Crime*, 77 HARV. L. REV. 1071, 1075 (1964).

[15]217 U.S. at 367.

[16]*Id.* at 378.

compared Weems' offense with other crimes generally considered to be more heinous but which carried much shorter and less severe sentences.[17] The immediate impact of the *Weems* decision was not as great as might have been expected; courts generally deferred to the legislative branch for a determination as to the appropriate degree of punishment.[18] In the 1958 case of *Trop v. Dulles*,[19] the Court once again invalidated a statute on cruel and unusual punishment grounds. Trop had been automatically stripped of United States citizenship upon conviction for wartime desertion. The Court held that the penalty of denationalization is contrary to the civilized principles embodied in the eighth amendment guarantee. While it was the type of punishment rather than the amount or length of punishment that came under judicial attack in *Trop*, the opinion did reaffirm the *Weems* position that the eighth amendment was much broader than a simple prohibition of torture.[20] Four years later, the Court in *Robinson v. California*[21] indicated for the first time that the courts could use the eighth amendment as a limitation on a legislature's power[22] to determine what acts may be made criminal. Robinson had been convicted and sentenced to 90 days imprisonment under a state statute which made addiction to narcotics a criminal offense. In overturning the conviction and striking down the statute, the Court stated:

> To be sure, imprisonment for ninety days is not, in the abstract, a punishment which is either cruel or unusual. But the question cannot be considered in the abstract. Even one day in prison would be a cruel and unusual punishment for the "crime" of having a common cold.[23]

Thus, the legislature was prohibited from imposing any criminal sanction for one's being a drug addict. Even after *Robinson*, a number of courts were still reluctant to interfere in the task of fixing penalties for crimes, a determination

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[17]The Court stated: "There are degrees of homocide that are not punished so severely, nor are the following crimes: misprison of treason, inciting rebellion, conspiring to destroy the government by force . . . ." *Id.* at 379.

[18]*E.g.*, Moore v. Aderhold, 108 F.2d 729 (10th Cir. 1939); Beckett v. United States, 84 F.2d 731 (6th Cir. 1936); Sansome v. Zerbst, 73 F.2d 670 (10th Cir. 1934).

[19]356 U.S. 86 (1958).

[20]Chief Justice Warren stated for the majority: "The basic concept underlying the Eighth Amendment is nothing less than the dignity of man." *Id.* at 100.

The Chief Justice's opinion in *Trop* is significant for its extremely broad interpretation of the word "unusual" in the context of the eighth amendment: "[T]he Court simply examines the particular punishment involved in the light of the basic prohibition against inhuman treatment, without regard to any subtleties of meaning that might be latent in the word 'unusual'." *Id.* at 100, n.32; *accord*, Furman v. Georgia, 408 U.S. 238, 331 (1972) (Marshall, J., concurring); *id.* at 376 (Burger, C.J., dissenting).

[21]370 U.S. 660 (1962).

[22]Although it was generally accepted after Louisiana *ex rel.* Francis v. Resweber, 329 U.S. 459 (1947), that the 8th amendment was applicable to the states through the 14th amendment, it was not until *Robinson* that the provision was specifically incorporated. Comment, *Revival of the Eighth Amendment: Development of Cruel-Punishment Doctrine by the Supreme Court*, 16 STAN. L. REV. 996, 1007 & n.50 (1964).

[23]370 U.S. at 667.

long thought to be exclusively a legislative prerogative.[24] In *Furman v. Georgia*,[25] a significant minority of the present Supreme Court indicated an unwillingness to inquire into the eighth amendment validity of any punishment set by a legislature.[26] For courts which have followed the *Weems-Robinson* example of judicial scrutiny of statutory penalties, there remains unresolved the problem of formulating a workable test for determining when a punishment is excessively cruel in proportion to the proscribed activity. Various criteria have been suggested, including an examination of the legislative purpose behind the punishment;[27] an inquiry as to popular sentiment regarding the punishment;[28] and an application of the comparative method originally set forth in *Weems*.[29]

Laws prohibiting marijuana first appeared in the 1930's. The then-prevailing view that marijuana use led to violence, insanity, and even death caused it to be classified as a narcotic in most states. Accordingly, penalties for its use were extremely severe.[30] During the past decade an increase in scientific knowledge concerning the effects of marijuana use has resulted in a modification of penalties by every state legislature as well as Congress.[31] Simple possession of small quantities of marijuana is now generally considered a misdemeanor.[32] The punishments prescribed, however, vary from state to state with little uniformity. The most common statutory penalty is a sentence of no more than 1 year and a fine of no more than $1,000.[33] However, it is still possible to receive

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[24]*E.g.*, Hedrick v. United States, 357 F.2d 121 (10th Cir. 1966); United States *ex rel.* Swanson v. Reincke, 344 F.2d 260 (2d Cir. 1965); Commonwealth v. Leis, 355 Mass. 189, 243 N.E.2d 898 (1969).

[25]408 U.S. 238 (1972).

[26]Chief Justice Burger, in a dissent joined by Justices Blackmun, Powell, and Rehnquist, stated:

> Whether or not provable, and whether or not true at all times, in a democracy the legislative judgment is presumed to embody the basic standards of decency prevailing in the society. This presumption can only be negated by unambiguous and compelling evidence of legislative default.

Id. at 384.

[27]*E.g.*, *id.* at 279 ("If there is a significantly less severe punishment adequate to achieve the purposes for which the punishment is inflicted . . . the punishment inflicted is unnecessary and therefore excessive.") (Brennan, J., concurring).

[28]*E.g.*, *id.* at 332 (Marshall, J., concurring); Rudolph v. Alabama, 275 Ala. 115, 152 So. 2d 662, *cert. denied*, 375 U.S. 889 (1963) (Goldberg, J., dissenting).

[29]*E.g.*, Hart v. Coiner, 483 F.2d 136, 140 (4th Cir. 1973), *cert. denied*, 415 U.S. 983 (1974).

[30]*See* Stern, *Reforming Marijuana Laws*, 58 A.B.A.J. 727 (1972).

[31]*E.g.*, MISS. CODE ANN. §§ 41-29-139(d)(2)(A),(B) (Supp. 1973), *amending* MISS. CODE ANN. §§ 41-29-139(a)(2),(c) (1972). For a summary of state statutes, see NATIONAL COMMISSION ON MARIHUANA AND DRUG ABUSE, FIRST REPORT, MARIHUANA: A SIGNAL OF MISUNDERSTANDING app., vol. 1, at 552-57 (1972).

The applicable federal statutes are found at 21 U.S.C. §§ 801-966 (1970).

[32]Greenstein & DiBianco, *Marijuana Laws—A Crime Against Humanity*, 48 NOTRE DAME LAW. 314 (1972).

[33]NATIONAL COMMISSION ON MARIHUANA AND DRUG ABUSE, *supra* note 31 app., vol. 1, at 552-57 (1972).

a sentence of 15 years[34] or a fine of $50,000[35] for possession of marijuana in parts of the United States. Attacks upon the constitutionality of marijuana laws began to appear in the 1960's at a time when the number of arrests for possession was increasing dramatically. Several defendants have attempted to challenge marijuana laws on equal protection grounds.[36] Although their arguments have met with some success,[37] the weight of judicial opinion indicates disfavor toward declaring marijuana laws an infringement of the equal protection guarantee.[38] Similarly, the few existing eighth amendment challenges have not evidenced a substantial degree of judicial acceptance of the proposition that marijuana penalties constitute cruel and unusual punishment.[39] The Supreme Court in 1972 declined to hear an appeal involving an equal protection-due process attack upon a marijuana conviction.[40]

In the instant case the court, relying on numerous documents[41] and the testimony of four expert witnesses,[42] made the following determinations: marijuana is not a narcotic drug; it is not addictive; it is relatively harmless to the user; and its use does not lead to criminal activity or violence. Applying the comparative approach used in *Weems v. United States*,[43] the court observed that under District of Columbia law the maximum punishment for illegal pos-

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[34]ALA. CODE tit. 22, § 258 (47) (Cum. Supp. 1973); COLO. REV. STAT. ANN. § 48-5-20(b) (Supp. 1971); R.I. GEN. LAWS. ANN. § 21-28-31 (Supp. 1973).

[35]ARIZ. REV. STAT. ANN. § 36-1020 (Supp. 1973).

[36]The legal theory in such cases is usually that classifying marijuana together with narcotic drugs such as heroin, opium, and cocaine is so arbitrary as to violate the 14th amendment's equal protection clause. *See* notes 37 & 38 *infra*.

[37]People v. McCabe, 49 Ill. 2d 338, 275 N.E.2d 407 (1971) (per curiam); *cf.* People v. Sinclair, 387 Mich. 91, 194 N.W.2d 878 (1972) (marijuana conviction reversed and the defendant discharged; two judges voted to reverse on equal protection grounds, two on the basis of cruel and unusual punishment, and two on an evidentiary error).

[38]*E.g.*, English v. Virginia Probation & Parole Bd., 481 F.2d 188 (4th Cir. 1973); United States v. Maiden, 355 F. Supp. 743 (D. Conn. 1973); People v. Summit, ___ Colo. ___, 517 P.2d 850 (1974); Commonwealth v. Leis, 355 Mass. 189, 243 N.E.2d 898 (1969); *cf.* United States v. Kiffer, 477 F.2d 349 (2d Cir. 1973).

[39]*E.g.*, United States v. Lozaw, 427 F.2d 911, 917 (2d Cir. 1970); Halprin v. United States, 295 F.2d 458 (9th Cir. 1961) (expressly declining to apply the comparative test set forth in *Weems*); United States v. Maiden, 355 F. Supp. 743 (D. Conn. 1973); Commonwealth v. Leis, 355 Mass. 189, 243 N.E.2d 898 (1969); People v. Lorentzen, 387 Mich. 167, 194 N.W.2d 827 (1972); *cf.* People v. Sinclair, 387 Mich. 91, 194 N.W.2d 878 (1972).

[40]State v. Kantner, 53 Hawaii 327, 493 P.2d 306 (1972), *cert. denied*, 409 U.S. 948 (1972).

[41]The most significant writings relied upon by the court were G. NAHAS, MARIHUANA —DECEPTIVE WEED (1973); NATIONAL COMMISSION ON MARIHUANA AND DRUG ABUSE, *supra* note 31; V. RUBIN & L. COMITAS, CANNABIS AND CULTURE (1974).

[42]The expert witnesses were Dr. Dorothy Whipple, M.D., Johns Hopkins University, called by the defense; Dr. Harold Kaufman, M.D., University of California, called by the defense; Dr. Floyd E. Anderson, Ph.D., University of Michigan, called by the prosecution; and Dr. Claire Theresa Harwood, Ph.D., Georgetown University, called by the prosecution.

[43]217 U.S. 349 (1910).

session of marijuana is much harsher than the maximum punishments for offenses involving direct dangers to people and property.[44] The court concluded that "the punishment prescribed for the possession of marijuana is extremely disproportionate to the offense proscribed,"[45] and therefore the statutory scheme violates the eighth amendment's prohibition against cruel and unusual punishments. In addition, the court rejected the prosecution's contention that the eighth amendment guarantee is available only after conviction and sentencing and that the proportionality between crime and punishment cannot be measured until a specific sentence has been imposed. Relying on *Robinson v. California*,[46] the court stated: "[S]tatutes themselves, and not merely particular sentences imposed, can be repugnant to the cruel and unusual punishment clause . . . ."[47] The court reasoned that society in general has a right to know that penalties prescribed by law are not unduly harsh and that one should not have to rely on the mere possibility that the maximum penalty will not be imposed in any particular case.

Under the eighth amendment there are at least two rationales[48] for attacking marijuana laws. One approach is to use the comparative method enunciated in *Weems* to determine that the punishment in question is greatly disproportionate to the offense. Although admittedly there are legitimate questions still to be answered concerning the effects of marijuana use,[49] today it is almost universally accepted by scientists that marijuana is not habit-forming.[50] There is evidence that marijuana is no more dangerous to the user than other potentially self-damaging activities such as chain-smoking cigarettes, driving without a safety belt, and drinking large amounts of liquor; each of these can result in serious physical harm and even death, but are subject to little or no criminal sanction.[51] To require by statute the same degree of punishment for possession of marijuana as is prescribed for possession of heroin or for the commission of

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[44]Among the offenses compared by the court were sale of firearms to minors (maximum penalty, $300); hit and run with personal injury resulting (maximum penalty, $500 and/or 6 months imprisonment); and driving while intoxicated (maximum penalty, $500 and/or 6 months imprisonment) Crim No. 46126-73, at 15 (D.C. Super. Ct., May 17, 1974).

[45]*Id.* at 16.

[46]370 U.S. 660 (1962).

[47]Crim. No. 46126-73, at 18 (D.C. Super. Ct., May 17, 1974).

[48]Other possible rationales are not discussed here in order to avoid confusion and because it is felt they are not directly applicable to the instant case. *See* text accompanying notes 27 & 28 *supra*.

For a good discussion of techniques which might be used to invalidate marijuana laws on eighth amendment grounds, see Comment, *Marijuana Possession and the California Constitutional Prohibition of Cruel or Unusual Punishment*, 21 U.C.L.A.L. REV. 1136 (1974).

[49]A recent study indicated that heavy marijuana use may result in impairment of male reproduction processes. N.Y. Times, Apr. 18, 1974, at 14, col. 1. It has also been reported that marijuana use may cause reduction of cell division and cell metabolism, brain shrinkage, genetic defects, and impairment of the body's immunity system. U.S. NEWS & WORLD REPORT, June 10, 1974, at 58. There is also considerable evidence to the contrary. *See* note 50 *infra*.

[50]*See* NATIONAL COMMISSION ON MARIHUANA AND DRUG ABUSE, *supra* note 31, at 31-66.

[51]Wheeler, *supra* note 5, at 863-64 n.109.

other very serious crimes would seem to be a violation of the eighth amendment under the *Weems* doctrine. A second approach is the *Robinson* rationale, which would employ the eighth amendment as a judicial tool to prohibit the imposition of *any* criminal sanction for marijuana possession. Applying this theory, if it can be proved conclusively that there is absolutely nothing harmful about marijuana or that its effects are so minor as to be comparable with drugs such as caffeine, the court then should declare the law itself unconstitutional. In view of the continuing debate over the effects of marijuana use, however, it would seem reasonable for today's courts to exercise extreme caution before making this type of conclusive finding. But the constitutional role of the legislatures, as the proper branch for setting penalties, should not be held to preclude the courts from a finding of fact as to the relative harmlessness of marijuana. Indeed, the judiciary's ability to review statutory punishments would be meaningless without the accompanying power to receive evidence as to the gravity of the offense in question and to make findings based thereon. As Mr. Justice Brennan stated in *Furman v. Georgia*:[52]

> Judicial enforcement of the [cruel and unusual punishments] Clause, then, cannot be evaded by invoking the obvious truth that legislatures have the power to prescribe punishments for crimes. That is precisely the reason the Clause appears in the Bill of Rights.[53]

Neither should the necessity for technical, scientific evidence regarding marijuana scare the courts into abdicating their duty to scrutinize legislative actions. It should be pointed out that a pretrial motion to dismiss, as in the instant case, should logically be permissible on the basis of either a *Weems* or a *Robinson* rationale.[54] If an action is so innocuous that it cannot constitutionally be prohibited, then it is axiomatic that a trial is pointless. Similarly, in view of the Supreme Court's opinion in *Weems* that even the minimum punishment was too harsh and that the charges should therefore be dismissed entirely, it is obvious that a pretrial motion to dismiss based on comparisons would have been proper in that case. According to this view, it follows that only those statutes in which the *minimum* penalty is excessive would be subject to the comparative test before trial.

In attempting to utilize the *Weems* comparative approach, the court in the instant case surprisingly dealt only with maximum penalties. The opinion failed to consider that the least severe penalty available in this case was a fine of $100. The court may have reasoned that the statute should be considered as a whole and that the maximum punishment was so disproportionate to the offense as to render the entire scheme unconstitutional. The Supreme Court, however, has

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Marijuana possession and use are separate and distinct from actions such as driving while under the influence of marijuana, which is highly dangerous and which should remain a criminal offense even if marijuana is legalized.

[52]408 U.S. 238 (1972).

[53]*Id.* at 269.

[54]*Contra*, United States v. Maiden, 355 F. Supp. 743, 749 (D. Conn. 1973); People v. Summit, ___ Colo. ___, 517 P.2d 850, 854 (1974); Commonwealth v. Leis, 355 Mass. 189, 243 N.E.2d 898, 906 (1969).

held that the unconstitutionality of one portion of an act need not defeat its remaining provisions.[55] Therefore, if the maximum punishments were the only offensive aspect, they could have been struck down separately or simply not imposed. Certainly, the court would not suggest, for example, that because a maximum penalty of death for the crime of bank robbery is too harsh, the entire statutory provision, including lesser punishments, should be thrown out and the accused allowed to walk free. The foregoing analysis, together with the court's rather emphatic findings as to the harmlessness of marijuana, leads to the almost inescapable conclusion that the court decided possession of marijuana should not be a crime at all. The puzzling feature of this reasoning, if indeed it is the basis for the instant decision, is that the court also applied the comparative test. If any penalty, even a relatively small fine, constituted cruel and unusual punishment, then there was no reason to compare other statutory penalties. Because of the relatively light minimum punishment possible under the District of Columbia Code, it is suggested that the comparative method for determining disproportionality was not a viable approach in the instant case; and, if the court felt marijuana possession should simply no longer be against the law, it should have clearly stated so. It must be emphasized, however, that the apparent incongruities in the instant opinion and the difficulty in ascertaining the basis for the court's decision should not suggest that the cruel and unusual punishments clause is necessarily a poor vehicle for challenging existing marijuana statutes. Viewed separately, and given the proper factual settings, the *Weems* and *Robinson* rationales appear to be available as grounds for future attacks on the severity of punishments for marijuana violations.

Roger F. Wicker

[55]United States v. Jackson, 390 U.S. 570 (1968). Jackson was charged with kidnapping, which carried a prescribed punishment of life imprisonment or death if a jury so recommended. Defendant contended that in order to assert his right to a jury trial he would have to risk execution. The Court agreed and declared the death penalty aspect of the statute unconstitutional, but the Court also held that the invalid penalty was "severable" and that the remaining provisions would remain in effect.

BOOK REVIEW

ATTORNEYS' FEES by STUART M. SPEISER
New York: Lawyers Co-Operative Publishing Company
1973. Pp. 680. 2 volumes. $55.00

*John P. Henson**

In the last 20 years, practicing lawyers have been faced with numerous changes in all aspects of law—whether defending an impecunious defendant in a criminal case or representing a large corporation in Tax Court. While the practicing attorney is striving to learn and master these new challenges in today's society, he has little time to organize his law practice. How does he know what fees to charge on a type of case he has never handled, and where does he look to find answers to these questions? Mr. Speiser's treatise helps an attorney find the answers.

The 2-volume work covers all aspects of attorneys' fees and law office management from the formation of an attorney-client relationship to the procedure used in collecting fees. Mr. Speiser begins each topic by discussing the general law in that area and then makes practical suggestions about day-to-day problems facing lawyers. Suggested forms are also provided for each general area. Methods and procedures for determining the reasonable value of an attorney's services are discussed, and illustrative awards for various types of cases are given with citations to cases where courts have upheld the validity of such fees.

Attorneys' Fees is different from many books which provide sample form contracts in that Mr. Speiser explains in detail how certain contracts should be constructed and explains the meaning and purpose of suggested clauses. In the section on retainer contracts, for example, the author begins by defining retainer fees. He then breaks the section down into various types of retainer fees, provides suggested forms, and gives some helpful practice pointers. An excellent section on contingent fee contracts follows and is covered in a similar manner.

A never-ending problem facing all attorneys is fee and billing procedures. One facet of this problem is illustrated by Mr. Speiser in his section on Law Office Management of Fees:

> Immediately after the trial the client says, "You saved my business, how can I ever thank you?" A week later, the client is saying, "Boy, was I great on the witness stand."

*B.B.A. 1969, J.D., 1973, University of Mississippi. Associate, Fraiser & Burgoon, Greenwood, Mississippi.

> The following week, the client is saying, "They never had a chance." Another week and the client is saying, "I could have won it myself."
>
> By the time the client gets the first bill he says, "What's your hurry?" And as time goes on, he then gets a reminder bill and he says, "That shyster."

In this section, the author covers fee-setting procedures and the practical matter of discussing a fee with a client. Suggestions are given to help create and maintain a good attorney-client relationship, which is one of the most valuable assets of an attorney's practice. For example, one method discussed to build this relationship is to keep the client well-informed on what is being done on his case. A case that will take months to complete might personally involve the client only two or three times. As Mr. Speiser points out, the well-informed client will accept the bill from his attorney with little hesitation when he knows that much time and effort went into "his" case.

With regard to billing procedures, Mr. Speiser suggests that all bills for services rendered be sent promptly since studies reveal a bill depreciates as much as 20 percent with a delay of as few as 20 days. Tables and formulas are provided to assist an attorney in determining the proper fee to charge and whether to charge a flat fee or an hourly rate. One method on fee and billing practice suggested by the author is the use of time cards which are basic to the determination of a proper fee for a particular matter.

Mr. Speiser's work covers many of the practical problems confronting every lawyer in the management of his practice. While it cannot serve as a substitute to the experience gained by the day-to-day practice of law, for the inexperienced attorney it is a valuable source of information on fees and law office management. For the experienced attorney, it can serve as a tool to correct and prevent many mistakes and faulty procedures in the law office. Mr. Speiser is to be commended for an excellent work and for providing an important contribution to the bar.

MISSISSIPPI LAW JOURNAL

GENERAL INDEX

VOLUME 45
1974

Published by
MISSISSIPPI STATE BAR
and
UNIVERSITY OF MISSISSIPPI SCHOOL OF LAW
UNIVERSITY, MISSISSIPPI

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